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THE CHAIRMAN'S REPORT

A Report by the Chairman
of the
Joint Economic Committee
of the Congress

December 28, 1989

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SUMMARY

This *Report* presents the views of the Chairman of the Joint Economic Committee. It covers the strengths and weaknesses of the economy and current economic policy. It also serves to summarize the Committee's activities for the year, as seen from the Chairman's perspective.

This is an opportune time to take stock of our economy, as we stand at the beginning of a new decade that is itself the doorway to a new century, even a new millennium. This portentous marking on the calendar should make us more conscious that our actions now will affect our Nation far beyond today. In recent years, in my judgment, that consciousness has been particularly lacking.

THE ECONOMY IN 1989

When the Joint Economic Committee filed its annual report in April, there were two major concerns: inflation (with the unemployment rate just over 5 percent, within the zone where economists start to worry about rising inflation); and a possible slowdown in the strong growth of net exports and business investment (which had fueled economic growth in 1988). In his testimony before the Joint Economic Committee, Federal Reserve Board (Fed) Chairman Alan Greenspan indicated that the Fed wanted to restrain inflation this year, if necessary sacrificing recent U.S. trade and investment gains. Many private economic forecasters were concerned that continuing tight money and high interest rates would slow economic growth to 2 percent or less.

In some respects, these concerns proved unfounded. Growth (including the bounceback from the 1988 drought) ran at over 2.5 percent through the third quarter. And though consumer prices rose at an annual rate of almost 7 percent between December 1988 and May 1989, inflation fell to a 4.5 percent average for the 12 months ending in October. This performance is testimony to the skill with which monetary policy has been conducted. Skill in the conduct of monetary policy, however, could not extend investment and export growth; in this respect, the policy flaw lies elsewhere. Investment in factories and machines did grow approximately 7.5 percent at an annual rate in the first half, and exports grew at a 13 percent rate. But this turned around in the third quarter, when growth of investment (4.4 percent) and exports (1.6 percent) tapered off significantly. This slowdown in economic growth also slowed job creation; employment in manufacturing has actually declined by 75,000 since the end of 1988, and the unemployment rate of 5.4 percent in November represents no improvement from a year ago. The slowdown in productivity growth in 1989, particularly the decline in productivity in manufacturing during the third quarter, will limit income growth and may put upward pressure on consumer prices.

CURRENT POLICY AND THE ECONOMY OF THE 1990s

While the worst in the short-term economic outlook was avoided during 1989, the events at year end highlight the price that we will pay in 1990 and beyond due to misguided long-term economic policies.

Even our short-term outlook is weak. Chapter I explains that we can no longer put unemployed workers and idle factories into use to boost economic growth without inflation, as we did over much of the decade. Slower real growth of no more than 2.5 percent per year appears likely. And even our present combination of 5 percent to 5.5 percent unemployment and 4 percent to 5 percent inflation, the object of some pride, can be easily oversold; in the early 1970s, similar indicators were called "stagflation" and were the cause of great consternation. What we have is like an on-time performance of the trains through adjustments of the scheduled arrival times, a revolution of lowered expectations.

We have failed to prepare for the future. But more important is the path on which our economy is set for the long term. Nobel laureate James Tobin, testifying before the Joint Economic Committee this year, characterized economic performance over the last decade as a demand-side success but a supply-side failure. This acknowledges the improvement in our unemployment and inflation rates, but points out our failure on many fronts to increase our productive capacity and thus augment future standards of living.

Our economy has been driven for most of this decade not by investment but rather by a binge of consumption that threatens our long-run standard of living and our standing as the world's leading economic power. The Federal Government is by far the largest single actor contributing to that consumption binge, but the fallout is widespread. Productivity growth, while better than in the late 1970s, is still well below that of the 1950s and 1960s. New business investment in excess of the replacement of old factories and machines is 20 percent below its share of national income of ten years ago; infrastructure investment is down from 2.4 percent of GNP in the 1960s to 1.0 percent in this decade; and our educational performance is weaker than our international competitors', witness our functional illiteracy rate estimated at 20 percent. What is worse, our sagging business investment has been financed by foreigners to a degree unprecedented in the post-World War II era. Therefore, a large portion of the income generated by that investment will flow abroad.

Our prosperity has not been shared fairly. Economists agree that the free operation of markets generally yields the greatest efficiency and production. But totally untempered markets can leave some participants behind. Chapter 1 concludes by noting that the gap between rich and poor is the greatest since the Census Bureau began these statistics in 1947. Furthermore, the poverty rate remains higher than it was in the 1970s, even after our extended economic recovery.

Our economic policies are the primary cause of the problems. Chapter II explains how our mix of tight monetary and loose fiscal policies contributed to these developments. Fiscal policy – the control of the overall Federal budget – became highly stimulative in the early 1980s. The large budget deficit, caused partly by the large tax cut, partly by the defense buildup, and partly by the deep recession, added to purchasing power in the economy. Monetary policy – the control of the availability of credit – was already turned toward restraint to squeeze out inflation.

Subsequent developments have confirmed these counterbalancing roles. Even though the economy has grown consistently since the end of the recession in 1982, the deficit has retreated little. The reason is the buildup of debt early in the decade, adding to debt service costs every year thereafter. With the fiscal policy foot thus stuck on the

accelerator, the monetary policy foot must remain on the brake. This combination is the worst preparation for the future. The large budget deficit drains National savings, and thus reduces our domestically financed investment. The tight monetary policy raises interest rates, and thus makes investment -- particularly long-term investment, with payoffs well into the future -- less attractive.

We are losing our competitive advantage in international markets. As Chapter III explains, the tight monetary policy needed to attract funds from abroad abruptly opened our economy to the world. The rush of foreign capital drove up the dollar and made imported goods cheaper here and our exports more expensive abroad. U.S. firms lost markets abroad that will be difficult and costly to regain, and foreign firms built strong markets here. Our trade deficit, according to the U.S. Treasury, is stalled at over $100 billion per year, breeding protectionist pressures that threaten mutually beneficial free trade and amicable relations with our allies. And as the Nation bought a flood of imports in excess of our exports, foreigners financed that excess with extensions of credit -- through both lending and purchases of U.S. assets. While we used to own more assets abroad than foreigners owned here, the situation now is the reverse.

Each year that we import more than we export and borrow the difference abroad, we increase our international debt and the consequent dividend and interest obligations. To reduce this burden, future generations will have to produce more goods and services without consuming them, to ship them to foreigners in satisfaction for the credit they extended us this decade. These debts are ill-considered because the borrowings have not been invested, so we leave our heirs no greater store of productive capital to meet these obligations.

NEW POLICIES FOR THE 1990s

We need new economic policies. We must recognize that responsibility for these policies is shared; both the executive and the legislative branches assented to them.

We must reduce the Federal budget deficit. Eliminating the deficit will not by itself solve all of our economic problems, or put an end to our National consumption binge. However, we will not solve our most pressing economic problems unless we reduce the deficit, which is the biggest single part of the drop in our savings. A nation that consumes more than it produces, and therefore must run a trade deficit, undermines its own credibility when it cites unfair treatment by other nations. Likewise, a Nation that must borrow large sums from abroad, and therefore must offer high interest rates, will not make the investments to raise productivity years down the road.

Spending is not the whole problem. Interest on our National debt is a legal obligation; the share of the budget devoted to debt service has doubled since 1977. Commitments to the elderly in social security and Medicare are respected on both sides of the political aisle. Chapter IV shows that all other spending has declined as a percentage of our GNP since the Korean war. Developments in the Soviet Union and Eastern Europe may provide budgetary relief, but witnesses before the Joint Economic Committee have pointed out that the backlog of unspent funds and the costs of closing bases and terminating weapons programs put major savings several years away. Further, Pentagon spending plans have been far in excess of the budgetary baseline of the Congress, and so we must make large cuts just to remain in place.

Interest, social security, defense, and Medicare account for 70 percent of total spending. Veterans and agriculture programs, Federal pensions (which were just recently reformed), and programs that represent neglected investments in our future such as infrastructure, research, education, justice, and the protection of our environment (which are likely to require increases, if any change) account for another 16 percent. This leaves only about 14 percent of spending, largely the safety net programs based on need. The deficit is equal to 12 percent of total spending. There is no way that the savings can be squeezed out of those programs.

We cannot eliminate the deficit without a tax increase. According to prudent economic assumptions, we cannot grow out of the deficit; waiting to do so will only add to our mountain of debt. Given the legal obligation of servicing the National debt, plus the programs that are accepted by the broad consensus of the American people, spending cuts alone will not suffice. A tax increase alone is not acceptable politically. Therefore, a balanced budget can be achieved only through a package political deal that includes spending cuts and a moderate tax increase.

Modest reform of the budget process could help. This year's budget agreement, despite the best efforts of a skilled team of Congressional negotiators, was a sham. Our progress has been hindered by rosy budgeting assumptions that wish away the deficit under a haze of smoke and mirrors. The Administration's deficit forecasts over the decade have been distinctly optimistic, and the Congress has repeatedly accepted those forecasts, as mandated by the current deficit reduction law, to minimize the needed spending cuts. I urge the Congress and the Administration to devolve the choice between the Administration and the Congressional Budget Office forecasts to a bipartisan commission. An independent assessment will encourage prudent budgeting. And if the size of our deficit problem is no longer hidden by smoke and mirrors, the Congress and the Administration will be put face to face with the problem, and forced more directly to provide real policy solutions.

But process reform is only a small part of the answer. At present, the deficit is like a hot potato passed back and forth between the Administration and the Congress, as each seeks political advantage, or at least the avoidance of political pain. If this game continues, we will all get burned, at some inescapable future date.

We should strengthen the political foundations of the Federal Reserve. The Federal Reserve has balanced our employment and price stability objectives with considerable skill, and so its conduct of policy is not an issue. When the Fed must make difficult decisions and comes under attack, however, it should not be vulnerable to charges of isolation and undue secrecy. The time to forestall such charges is now, when comparative economic calm and high regard for the Fed prevail. Representative Byron Dorgan (D-N.D.) and I have introduced a measured bill to extend to the Fed the same standards of openness and accountability that apply to other agencies, without increasing executive or legislative control over monetary policy. It would make the Fed stronger, more able to weather times of controversy, and no less independent.

Targeted Economic Policies

The *Report* concludes, in Chapter V, with an evaluation of policy actions taken (or not taken) during 1989 that affect particular sectors of, or participants in, the economy. In some instances, such as the repeal of the Medicare Catastrophic Care Act, policy has been left in limbo. In others, like the Medicare payment reform, promising steps may yield long-term benefits.

We need to invest more in our children and educate our people better. We put the development and even the safety of our children at risk if their parents must work but cannot obtain adequate care. Head Start can be a cost-effective tool in improving our long-run economic performance. We also need to improve elementary and secondary education and adult literacy programs to match the performance of our commercial competitors.

We must address our environmental problems quickly and decisively. Market-based solutions should be used where they can achieve a clean environment at lower, fairly distributed costs. Polluters should pay the costs of their actions.

We must learn our lessons from the thrift bailout and deregulation. Even with the enactment of the 1989 legislation, the thrift crisis may not be over. We must closely scrutinize the deposit insurance systems and move quickly if the funds allocated, the safety and soundness supervision, or the new rules prove inadequate. We should capitalize on the efficiency gains of deregulation in other industries, such as transportation, but also recognize the need for antitrust enforcement in changing markets, such as air travel.

We must strengthen our infrastructure base. Sagging infrastructure has slowed our productivity growth. Even our Nation's statistical base has emerging weaknesses that threaten the policymaking process.

We must improve rural America. Our rural areas face a series of challenges that extend beyond agriculture. Investments in infrastructure will assist in all forms of development; Third World debt relief and trade liberalization will expand farm export markets.

We must do better in the world economy. To increase exports and reduce our dependence on foreign funds, we should solve our budget deficit and use more effectively the international organizations to meet the challenges of Third World debt and the restructuring of Eastern Europe. We need to remove barriers to trade with the East Asian economies, where only incremental progress has been made, and forestall new barriers in the European Community's 1992 initiative.

We should avoid undue incentives or disincentives to corporate mergers. Mergers and takeovers can encourage American business to operate efficiently, but there have been excesses. Radical tax cuts or penalties are not the answer.

We must encourage productivity through knowledge. While Government cannot "micro-manage" or bankroll industry, improvements in productivity can be achieved through the development and diffusion of knowledge, technology, and best industrial practice.

We should keep fair and neutral tax policies. The capital gains tax cut proposed this year would be unfair, costly, and ineffective. Our economic performance since tax reform justifies continued adherence to low tax rates with the fewest possible exceptions.

Our economic picture, then, is mixed. We should not ignore our progress on inflation and unemployment. But we must face the challenges that we have left for ourselves, especially in our budgetary imbalance, and in our trade and financial relationships with the rest of the world.

I commend this *Report* to my colleagues as we consider the legislative agenda for 1990.

CHAPTER I. OVERVIEW AND OUTLOOK

The economic recovery of the 1980s has matured. The unemployment rate is no longer dropping as it did from 1983 to 1988 and the pace of economic growth has slowed accordingly. We can no longer grow by putting unemployed workers and idle factories back into production without risking unacceptable inflation. The challenge ahead is one we have neglected in recent years – to promote noninflationary long-term growth at high employment and spread the benefits of that growth widely among the American people.

Nobel laureate James Tobin, testifying before the Joint Economic Committee, has characterized economic performance over the past decade as a demand-side success but a supply-side failure. By this, he means (a) we have succeeded in achieving the short-run goals of economic policy – high employment without excessive inflation -- by giving people enough spendable income to keep workers employed and factories busy meeting their demand for goods and services, but (b) we have failed to step up growth in the economy's capacity to supply goods and services from the sluggish pace of the 1970s.

As we enter the eighth year of economic expansion following the deep 1981-82 recession, we still have a low national saving rate, modest productivity growth, a deteriorating infrastructure, a large trade deficit, and mounting international debt. Moreover, too many Americans have failed to see their own standard of living rise as the overall economy has grown. Although we have achieved low unemployment with reasonable price stability, we have not laid a satisfactory foundation for future growth in our living standards.

ECONOMIC GROWTH IN THE SHORT RUN AND THE LONG RUN

Since the 1981-82 recession, unemployment has declined, and idle industrial capacity has been put back into use. These trends have been desirable in their own right, and they have also given a boost to the rate of growth of production in the economy. Our productive capacity was increased at a faster rate than would be possible with just our new workers leaving school, and just our newly constructed factories and machines. This meant that the total amount of production that we could share -- our GNP -- could grow more rapidly.

In the last year, however, this situation has changed. Our unemployment has fallen close to what we would expect in a smoothly functioning economy, where those looking for work are largely new entrants to the labor force and upwardly mobile experienced workers taking a normal period of time finding the right jobs. (We put aside for the moment the serious National problem of discouraged workers lacking valuable skills.) Previously idle factory capacity is also generally back in use. Thus, the growth in our productive capacity is slowing, to include only the new workers leaving school and the newly constructed factories; and the growth rate of our GNP has slowed accordingly.

Economic policy has been successful in its short-run task, putting those idle workers and factories back into use without igniting inflation. In the past, outbreaks of

inflation have brought on recession, increasing unemployment and sending the entire process back to the beginning.

However, there is also a long-run policy task of increasing our rate of economic growth year after year after idle workers and factories are back in use. That boils down to increasing productivity, by devoting more of our resources to building economic strength for tomorrow rather than achieving gratification today. In this long-run policy task, unfortunately, we have been far less successful.

This chapter covers first our short-term economic outlook for maintaining high employment without inflation; and then the prospects for our standard of living over the long run.

Background: Potential GNP

Since 1973, the last year the unemployment rate was lower than it is now, the average annual rate of growth of the economy has been about 2.6 percent (down from 3.5 percent in the two decades prior to 1973). The economy has grown in fits and starts, however, with periods of recession mixed in with periods of recovery and more rapid growth.

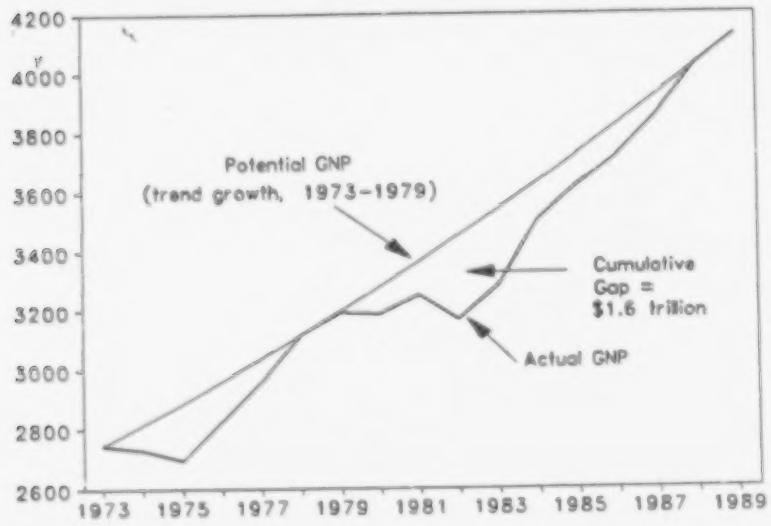
Suppose, instead, that the economy had grown continuously at about that 2.6 percent average rate since 1973. That would have held unemployment at about the same 5 percent rate, which we now consider close to full employment, from 1973 through 1989. We would have avoided the years of recession in which workers and factories were idle, and the economy produced less than it could.

In economists' parlance, an economy growing steadily at full employment is producing its potential GNP. The rate at which its output grows if it maintains full employment is the rate of growth of potential GNP.

The short-run challenge for economic policy is to keep our actual GNP at its potential. Recessions are to be avoided, but so too are periods of excessive demand that push the economy up against its capacity constraints. Potential GNP is not an absolute ceiling, but rather what can be produced on a noninflationary basis; there is always some unemployment and idle capacity in the economy, even in "high" employment years like 1973 and 1989. Most economists believe that there is substantial risk of rising inflation from trying to push actual GNP above potential for an extended time -- as in the late 1960s, for example. Under such conditions, producers must bid scarce labor and materials away from one another to expand production, and find it relatively easy to pass these higher costs on to consumers. Such price pressures invariably lead to recession, and push production below its potential.

The cost of departures from potential GNP are considerable and irretrievable. When workers and factories are idle, their production is lost, and can never be regained. As a rough rule of thumb, each percentage point rise in the unemployment rate above its high employment level corresponds to roughly a two percentage point loss in GNP relative to its potential. Because of the frequency and depth of our recessions since 1973, we have cumulatively lost economic well-being of about $1.6 trillion (see Figure 1.1).

Figure I.1
Actual and Potential GNP
(Billions of 1982 dollars)



Source: National Income and Product Accounts and JEC Staff calculations.

Gaps between actual and potential GNP can emerge for a variety of reasons, including deliberate restraint to fight inflation, policy errors, and unexpected shocks from our private sector or from abroad. In any of these cases, however, the gap is a measure of our failure to maintain enough spending power in the economy to keep our workers and factories busy. During the 1970s, when the economy was buffeted by oil and food price shocks, we seemed unable to reduce inflation and unemployment simultaneously; and so any progress made against unemployment was soon lost to the pressures of inflation. Inflation fell sharply in the 1981-82 recession, but only at the cost of unemployment above 10 percent, and an 8 percent to 10 percent drop of GNP below

its potential. Since 1983, however, we have generated sufficient demand to close the gap between actual and potential GNP without higher inflation, leading to Professor Tobin's characterization of this period as a demand-side success.

While the short-run economic policy challenge is to keep actual GNP at its potential, over extended periods of time the rate of growth of potential GNP is the limit on society's well being. Thus, the long-run challenge for economic policy is to boost the rate of growth of potential GNP to achieve faster growth in our standard of living.

Reducing inflation and unemployment is important for meeting our short-run policy challenge. More important over the long run, however, is encouraging the kinds of spending that promote economic growth while discouraging excessive attention to current gratification. Thus far in the 1980s, we have done better at meeting our inflation and unemployment goals than at shifting the pattern of spending away from consumption and into investment; the outlook is for more of the same.

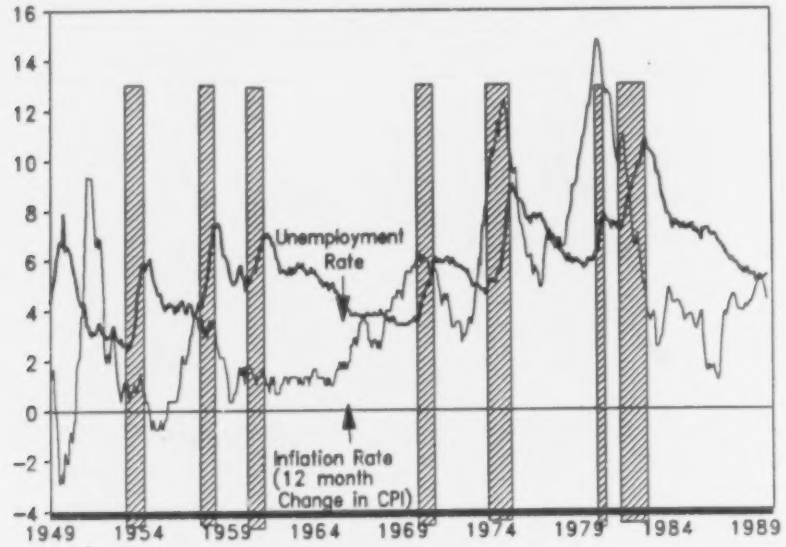
DEMAND MANAGEMENT AND THE SHORT-RUN ECONOMIC OUTLOOK

Unemployment and Inflation

The length of the economic recovery and our ability to push unemployment below 5.5 percent without rapidly rising inflation are impressive, by the standards of 1980, when unemployment was above 7 percent and inflation was raging at a double-digit rate. It is worth remembering, however, that in 1971 we applied the label "stagflation" to a combination of inflation and unemployment rates similar to what we have now. Still, most economists agree with Federal Reserve Chairman Greenspan that we are now in the "full-employment zone," where it would be difficult to reduce unemployment much more without risking rising inflation. By the same token, further gains against inflation are unlikely unless we are willing to tolerate substantially higher unemployment.

Figure I.2 shows how remarkable this recovery has been compared to most previous recoveries in avoiding rising inflation as the unemployment rate has come down. But it also reminds us that the economic expansion of the 1960s produced unemployment rates lower than today's before the Vietnam War spending led to faster inflation. The current expansion has also benefitted from a sharp decline in oil prices after a steep climb in 1979-80. Finally, Figure I.2 shows that rising inflation has almost never been reversed without a recession.

Figure I.2
Inflation and Unemployment
(Monthly data)



Note: Shaded areas represent recession.
Source: Department of Labor, Bureau of Labor Statistics.

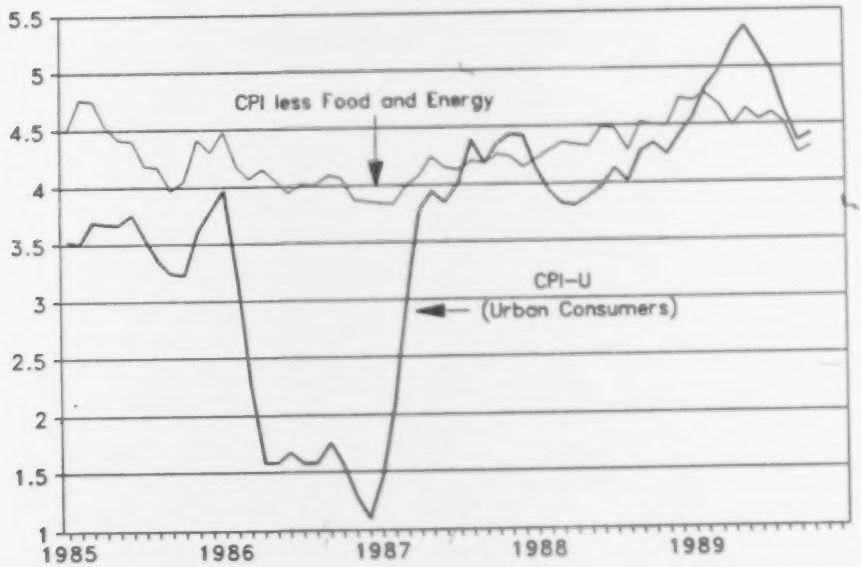
Looking ahead, the economy continues to face a difficult passage between the Scylla of rising inflation and the Charybdis of recession. For most of the recovery, the availability of unemployed workers and idle industrial capacity, together with substantial foreign competition, were effective checks on inflation. They also provided policymakers with the freedom to stimulate the economy whenever it showed signs of faltering, with minimal risk of inflation. Now, in contrast, an unexpected spurt of demand would be much more likely to push the economy up against its production constraints and encourage producers to raise prices. Yet if policymakers (primarily the Federal Reserve) do not respond to signs of weakening in the economy, slower-than-expected demand growth could plunge us into recession. It will require both continued good luck and good judgment by the Fed to keep the recovery going without rising inflation, but such an outcome is certainly possible.

Concern over inflation will almost surely keep the Fed from allowing the economy to grow much faster than the 2.5 percent rate that appears to hold unemployment in the 5.0 to 5.5 percent range. Witnesses at our hearings have cautioned, however, that the economy often slips into a recession when growth slows for more than a quarter or two to the 1 to 2 percent range that some observers would call a "soft landing." Nor would

such a modest slowdown in the economy reduce inflation much; the only way we have been able to achieve a substantial permanent reduction in the inflation rate since the end of World War II has been to put the economy through a recession. Although the Fed appears to want a lower inflation rate, it does not appear willing to risk a serious recession to achieve that objective.

Barring a severe recession or an unexpected spurt in demand, inflation is likely to remain in the 4 percent to 5 percent range. However, special factors could cause it to rise faster or slower for short periods of time. In 1986, for example, sharp declines in energy prices held down increases in the Consumer Price Index (CPI); and at the beginning of 1989, there were very large monthly changes in the CPI and the Producer Price Index (PPI) that did not continue through the rest of the year. Figure I.3 uses a measure of "core" inflation that excludes such temporary fluctuations in food and energy prices to show that the trend in inflation is steadier than the month-to-month figures would suggest. Sudden change is unlikely unless we experience sharp movements in the dollar and import prices.

Figure I.3
CPI and Core Inflation
(12-month percent change)



Source: Department of Labor, Bureau of Labor Statistics.

Employment costs have recently begun to rise faster than product prices, after several years in which they rose less rapidly. Hourly labor costs as measured by the Employment Cost Index (ECI) rose 3.3 percent in 1987, 4.9 percent in 1988 (4.4 percent excluding the social security tax hike), and 4.6 percent in the first nine months of 1989. After several years of wage restraint, we are likely to see a more normal relationship between wages and prices in which real wages increase at about the same rate as labor productivity (output per hour). We cannot rely further on wage restraint to reduce inflation, but if wage and benefit increases do not exceed productivity gains, they will not aggravate inflation (although we can perhaps expect a one-time boost to total compensation early in 1990 when the next Social Security payroll tax increase kicks in).

Although the current inflation rate is too high to accept with equanimity, there is little that the macroeconomic tools of monetary or fiscal policy can do to lower it further when the economy is operating in the full-employment zone. We can, however, attack inflation with microeconomic policies that boost productivity and increase competition. Such policies could include the removal of trade barriers that artificially inflate prices, and the reform of regulations that protect producers from competition.

The Composition of Demand

Spending in the economy can be divided usefully into four categories based on who does the spending and for what purpose: consumption expenditures by households; investment expenditures (purchases of machines, factories, and newly built housing); government purchases of goods and services (federal, state, and local); and net exports (the difference between what we sell to the rest of the world and what we buy from them). At different times, different combinations of these spending categories have kept the current economic recovery going. On balance, however, the 1980s have seen a shift in the composition of demand toward consumption and away from other spending categories (Table I.1).

Between 1960 and 1979 we produced more than enough to meet our domestic spending needs, on average, and we sold the surplus abroad (hence our positive net export balance). In the 1980s, in contrast, we have spent more than we earned and we have financed the difference by borrowing from the rest of the world. The shift in our net export position from positive to negative corresponds to a shift in our status from an international lender to an international borrower. Before, we saved more than enough to meet our domestic investment demand and we invested the surplus abroad; now we save less than what we need to finance domestic investment and we have become dependent on foreign lenders. Investment financed by our own saving is 5.0 percentage points of GNP lower now than it was ten years ago. The addendum to Table I.1 shows that national saving has fallen in part because of a drop in private saving and in part because of the federal budget deficit.

Table I.1
The Composition of Domestic Spending and GNP, 1960-89
(Percent of GNP)

	Average 1960-79	1979	1989	Change 1979-89
Consumption	62.7	62.5	66.3	3.8
Government Purchases	20.4	18.7	19.8	1.2
Investment	16.0	18.1	15.0	-3.1
Total Domestic Spending	99.0	99.3	101.1	1.9
Net Exports (positive entry corresponds to net U.S. lending abroad; negative entry corresponds to net U.S. borrowing abroad)	1.0	0.7	-1.1	-1.9
Addendum: U.S. Saving Available for Private Investment (GNP less consumption and government purchases)	16.9	18.9	13.9	-5.0
Federal Budget Surplus	-1.3	-0.6	-2.8	-2.2
All other Domestic Saving	18.2	19.5	16.7	-2.8

Source: National Income Products Accounts. Items may not add to totals due to rounding.

There is nothing in the economic outlook to suggest a fundamental change in the composition of our spending. If we are lucky enough to avoid a recession, it is likely to be because consumer spending continues to be strong. Until we make fundamental changes in our fiscal policy by reducing the federal budget deficit, real interest rates are likely to remain high, discouraging investment spending. Similarly, the dollar is likely to remain relatively strong and the trade balance is unlikely to show much improvement. If we do slip into a recession, business plant and equipment investment will become very weak. On balance, therefore, the consumption-oriented pattern of economic growth we have seen in the 1980s is likely to continue if we do not change our policies.

Although consumer spending has been good for the economic recovery, it would have been preferable to have had more balanced economic growth, with greater investment and net exports and less consumption. As discussed in the next chapter, such an outcome might well have been achieved with a less expansionary fiscal policy and a more expansionary monetary policy.

Instead, we find ourselves with low national saving and high real interest rates that increase our vulnerability to a financial panic or a run on the dollar. These risks are discussed in Chapters II and III. These risks are real, but they should not be overstated.

After all, some amount of financial fluctuation is to be expected in a market economy and need not threaten employment and production.

Our experience following the 1987 stock market panic gives reason to be cautiously optimistic about these risks from a short-term viewpoint. True, concern that the United States is not making sufficient progress to reduce its budget and trade deficits could cause a flight from the dollar, but eventually the dollar would fall sufficiently to make dollar-denominated assets cheap enough to attract back international investors. Moreover, U.S. output and employment growth were largely unaffected by the turbulence in the foreign exchange and bond markets that led to the stock market plunge in 1987, and the market itself recovered from its losses. Concern with corporate debt and "junk-bond" financing caused a stock market "hiccup" this October, but once again there was no clear impact on the real economy and no permanent collapse in the market itself. Thus, the economy generally appears resilient in the face of shocks. Nevertheless, there is considerable pain in unemployment and bankruptcy when our shock absorbers do not work, and we would do well to adopt more prudent policies to reduce our exposure to unnecessary risk.

Summary of the Short-Term Outlook

Seven years of economic expansion have reduced unemployment close to its full-employment level, and hence eliminated the gap between actual and potential GNP, without generating excessive inflation. Potential GNP growth of about 2.5 percent per year will now constrain the economy. The Federal Reserve does not appear willing to engineer a recession to lower inflation, but there are signs of weakness in the economy now, and the Fed may not be willing or able to prevent a recession. As long as the Fed can keep economy growing at a pace that keeps unemployment in the 5 percent to 5.5 percent range, however, inflation likely will remain in the 4 percent to 5 percent range. Thus, our success in managing demand to prevent excessive inflation or unemployment may well continue. But we are likely to continue to consume too much and invest too little. Interest rates are likely to remain high, and the trade deficit is unlikely to improve substantially.

THE SUPPLY SIDE AND THE OUTLOOK FOR LONG-TERM GROWTH

Our success in reducing unemployment (or moving actual GNP up to its potential) has not been matched by success in raising the underlying long-run growth rate of the economy (or the growth rate of potential GNP), and hence our standard of living over the long term. Indeed, the same policies that stimulated consumption and thereby helped to decrease unemployment – primarily fiscal stimulus from large budget deficits – have held back investment, and hence expansion of the economy's productive capacity. Compared to the 1950s and 1960s, when potential GNP grew at better than 3.5 percent per year, recent growth in potential is about the same 2.5 percent per year that it was in the 1970s. (Chapters II and III discuss these policies and their consequences in greater detail.)

There are two major determinants of the rate of growth of potential GNP: (1) the rate of growth of the labor force (more precisely, hours worked), and (2) the rate of growth of productivity (output per hour worked). Growth in the labor force or hours worked alone does little to raise our standard of living; more is produced but more of

us have to work harder or longer to produce it. Growth in productivity, by contrast, results in more output for the same amount of effort. Table I.2 shows that productivity growth was stronger in the 1980s than it was in the 1970s but still only half what it was in the 1948-73 period.

Table I.2
Growth in Output and Its Determinants
(Percent per year)

	1948-73	1973-79	1979-87
Growth in Output	3.7	2.5	2.7
Less: Growth in Hours	0.7	1.9	1.3
Equals: Growth in Output per Hour	3.0	0.6	1.4
Attributable to:			
Growth in Capital per Hour	1.0	0.5	0.8
Residual Growth in Productivity	2.0	0.1	0.6
Addendum:			
Growth in Capital Services	3.6	3.5	3.5
Growth in Capital per Hour	2.9	1.6	2.2

Source: Bureau of Labor Statistics data on output and productivity in the private business sector.

Over the next several years, labor force growth is likely to slow now that the "baby boom" has been absorbed into the labor force (although immigration can be a source of new workers). The key to raising potential GNP and to raising our standard of living will therefore be our ability to raise productivity.

There is much that economists do not know about the determinants of productivity growth, but one thing they do know is that productivity increases when we invest in new capital to equip our workers with more and better factories, machines, and technology. The addendum to Table I.2 shows that the Bureau of Labor Statistics measure of capital services has grown at a roughly constant rate over the entire postwar period. Unfortunately, with a growing labor force and declining productivity growth from other factors (sometimes called "residual productivity" growth, the portion of labor productivity growth attributable to managerial improvements, technical progress, and other factors that increase the amount of output that can be produced from a given amount of capital and labor), we have not expanded the capital stock fast enough to maintain past rates of growth in labor productivity.

Other evidence suggests that we are investing less now than we used to (Table I.3). Corrected for inflation, we devoted roughly the same share of national income to gross investment in the 1980s as we did in the 1970s, but gross investment includes replacement of old capital as well as net additions to the capital stock. Net investment tells us the rate at which we are expanding the quantity of tools and facilities needed to boost the productivity of an expanding work force, and net investment is 20 percent lower as a share of national income than it was ten years ago.

Table I.3
Measures of Real (Inflation-Adjusted) Investment

	1960-79	1979	1988	Change 1979-88
Gross	16.9	18.0	17.8	-0.2 (- 1%)
Net	8.0	8.2	6.6	-1.6 (-20%)

Note: Gross Investment expressed as a percentage of Gross National Product; Net Investment expressed as a percentage of Net National Product

Source: National Income and Product Accounts

Background: Measuring Investment

Interpretation of investment statistics is controversial. On the one hand, many analysts believe that the price correction applied to computers – a major component of new investment – is too large, with the result that the inflation-adjusted investment figures overstate true additions to the capital stock. On the other hand, for a variety of reasons, including high real interest rates in the 1980s, businesses have concentrated their investment in short-lived rather than long-lived assets. This choice implies that the capital stock will wear out and need to be replaced sooner; hence businesses have to set aside larger allowances for depreciation. To some extent, net investment may understate the contribution of investment to productivity growth because it fails to capture productivity gains achieved by replacing worn-out old capital with better quality new capital, in addition to the benefits of adding new capital beyond what is needed for replacement. Still, the investment record of the 1980s is rather lackluster, especially in light of the growing labor force, slow productivity growth, and substantial fraction of investment that is financed by foreign borrowing rather than our own domestic saving.

Beyond new plant and equipment, the determinants of productivity growth include education and training of the labor force and the creation of new knowledge and refinement of existing production processes through research and development. The private economy also requires a healthy social infrastructure (roads and bridges that are in good repair, for example). Recently the Joint Economic Committee was presented with a letter signed by 327 economists, including 6 Nobel Prize winners, stating that underinvestment in human skills and in physical infrastructure – in new construction, but perhaps more important, in repairs and maintenance – is impairing economic growth and reducing our competitiveness. The letter states:

> In addition to our trade and fiscal deficits, America faces a 'third deficit'--the deficiency of public investment in our people and our economic infrastructure. This deficit will have a crippling effect on America's future competitiveness.

Public investment has been squeezed by government at all levels. Outlays for infrastructure have declined from almost 2.4 percent of GNP during the late 1960s to barely 1.0 percent of GNP during the 1980s. At the federal level, infrastructure outlays have declined from almost 12 percent of nondefense spending in the early 1960s to just over 4 percent in 1988. Growth in public infrastructure has lagged behind growth in private capital and behind growth in the labor force. Public capital per worker peaked in the early 1970s and has been declining ever since.

The United States cannot afford to neglect productivity growth in an increasingly competitive international economy. Although we still enjoy higher productivity than our international competitors in many industries, their productivity is growing faster than ours. We have already been overtaken in some industries, including some high-tech industries.

There are many explanations why U.S. productivity growth lags behind that of our international competitors, but one that shows up in statistical studies is inadequate public investment. Such a statistical connection should not be surprising: deteriorating roads lead to increased vehicle maintenance costs and air traffic delays produce missed meetings and wasted time, for example. There is a more direct connection between private sector productivity and public investment in education. Unskilled workers cannot master the complex processes that characterize best-practice manufacturing techniques. A recent Joint Economic Committee report has documented the U.S. education deficit.

In summary, the United States is not making the kinds of public and private sector investments that are necessary to increase our productive capacity. The flagging productivity growth and sluggish long-term growth in GNP that were a source of concern in the 1970s are still with us.

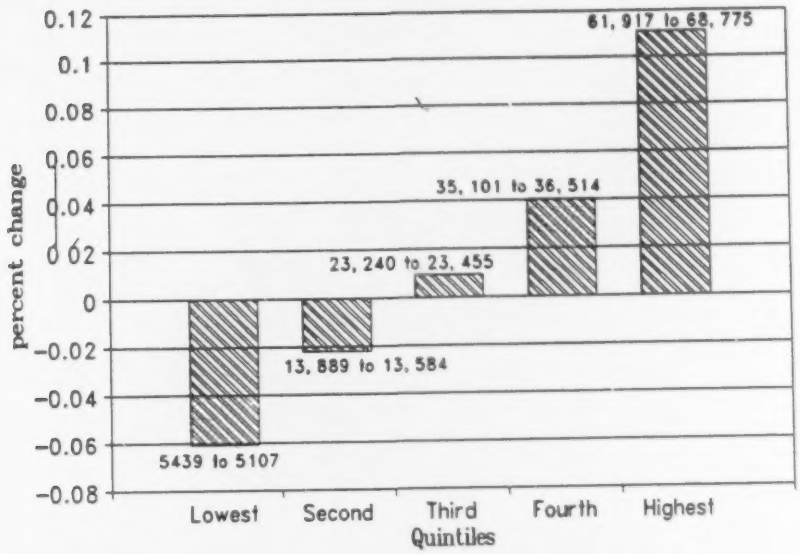
TRENDS IN POVERTY AND INCOME DISTRIBUTION

The income of the average American family was higher in 1989 than it was at the beginning of the decade, but growth in income has not been spread evenly across the population. In 1988 (the latest year for which data are available), the richest 40 percent of all families in the United States received 68.0 percent of all family income, compared to 65.8 percent in 1979. The poorest 40 percent of all families received 15.3 percent of all family income, compared to 16.8 percent in 1979. This disparity in income shares is the largest since 1947, when we first began to keep these statistics.

Figure I.4 shows that, measured in 1988 dollars, average family income in the richest 20 percent of the population rose 14.2 percent between 1979 and 1988 (from $74,403 to $84,938); average family income in the poorest 20 percent of the population fell 4.3 percent (from $9,278 to $8,880). Average family income in the second richest 20 percent of the population rose 7.7 percent (from $43,001 to $46,330); average family income in the second poorest 20 percent fell 0.2 percent (from $20,697 to $20,655).

Average family income in the middle 20 percent of the population rose 3.2 percent (from $31,224 to $32,238).

Figure I.4
Changes in Family Income, 1979-1987
(Percent change in average income by population quintile measured in constant 1988 dollars)



Source: U.S. Department of Commerce, Bureau of the Census.

A second perspective on the uneven gains from economic growth in the 1980s emerges from the behavior of productivity and worker compensation (wages and fringe benefits). For most of the postwar period, workers' earnings grew apace with workers' productivity. During the past ten years, however, earnings growth has lagged behind productivity growth, while non-labor income (interest, dividends, and rents) has been growing faster than labor income. Although many American households have non-labor income (pension earnings, interest on savings accounts, and IRA earnings, for example), the distribution of non-labor income is much more highly skewed toward those at the top of the income distribution than is the distribution of labor income.

Sluggish growth in labor income is uncharacteristic of business cycle recoveries, but two pertinent features distinguish this recovery from past recoveries. First, the 1980s have been marked by substantially higher real interest rates and less net investment than previous recoveries. Second, pressure on export- and import-

competing industries -- traditionally been among the highest paying -- has kept wages down.

Finally, Americans with incomes below the poverty threshold have not fared well as the general economy has prospered. To be sure, the official poverty rate has dropped since the 1981-82 recession, but at 13.1 percent (about 32 million people), it remains above what it was in 1979, the last high employment year.

Moreover, there is reason to believe that the official poverty measure understates the true incidence of poverty. Our current definition of poverty is based on consumption patterns from 1955, when the majority of households did not have televisions or even telephones and when a large majority of the poor lived in housing that lacked indoor plumbing, central heating, or adequate cooking facilities. A recent Joint Economic Committee staff study shows that if the same methodology used to construct the official poverty threshold were applied to 1980s consumption patterns, nearly one American in four would be classified as living in poverty and the poverty rate in 1988 would be higher than it was in the recession year 1982. This latter calculation is based on the reasonable proposition that a society's definition of what constitutes a minimally acceptable income increases as the society becomes richer.

Upper-income Americans were the main direct beneficiaries of tax cuts in the early 1980s. There is no evidence in these data that those benefits have trickled down to lower-income Americans. It is one thing to have income inequality increase when the economic pie is expanding rapidly and most people's standard of living is improving; it is quite another when the standard of living of roughly 60 percent of American families stagnates.

CONCLUSION

Economic policy since 1982 has been successful in reducing unemployment without reviving inflation. It has not been successful in improving our prospects for long-term growth or in spreading the benefits of economic growth widely among our citizens. The following chapters describe in greater detail where we are and how we got here. They also describe changes in the direction of economic policy needed to build on the gains we have achieved thus far and extend those gains to include long-term growth and a fair sharing of economic prosperity.

CHAPTER II. MACROECONOMIC POLICY

Although a wide variety of factors influence the economy -- the pace of technological change, private attitudes toward saving and credit use, the views of foreign investors, even the weather through food prices -- one particular set of influences is uniquely the responsibility of the Federal Government. These are the macroeconomic policies designed to steer the overall economy: fiscal policy, the overall management of the Federal budget, and monetary policy, the management of bank reserves and key interest rates.

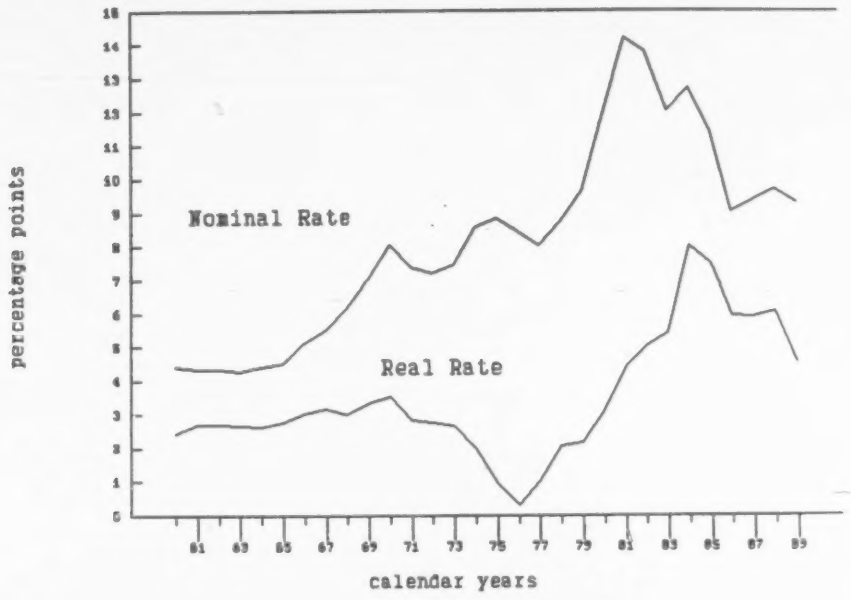
The preceding chapter showed that, judging by the current performance of the economy, some things have been done right in the past deacde. Inflation and unemployment rates, jointly, are at their lowest levels since the early 1970s. But a further look shows some weak points in our current prosperity that are directly related to macroeconomic policies. Unprecedented Federal budget deficits, combined with the legacy of anti-inflationary monetary policy, have resulted in unusually high interest rates (see Figure II.1). These high rates have strained our debt-intensive sectors (such as housing and agriculture), our financial institutions, and developing countries that have borrowed in the United States. Perhaps most important, these policies have increased uncertainties for the economy and threaten sizable reductions in investment for our future if foreign financing should become more costly.

MACROECONOMIC POLICIES: LAYING THE FOUNDATION FOR OUR FUTURE

Chapter I explained that our economic performance can be measured in the short run -- whether we reduce unemployment and inflation -- and in the long run -- whether we build our productive capacity and accelerate the growth of our standard of living. The Federal Government's macroeconomic policies can determine our success in attaining both of these sets of objectives. Normally, economists would charge our monetary policy with the task of controlling inflation over the long run, and assign the maintenance of economic growth to fiscal policy. In practice, however, how we handle one of these policy tools can constrain how we use the other; and the mix that we ultimately choose can be crucial.

In this decade, our Federal budget deficit has directly drained our National savings and reduced our capacity to finance our own investment. But it has also necessitated a tight monetary policy and high interest rates, to attract needed foreign capital and restrain the economy. The high interest rates have discouraged investment in general, and long-term investment in particular; it simply takes a higher return from an investment in a factory or a machine to outperform a high-yield investment in a bond or bank deposit. Further, the wide fluctuations in interest rates and currency exchange rates caused by this policy mix have increased uncertainty in the economy; this further biases business choices toward the short run.

Figure II.1
Long-Term Interest Rates



Note: The nominal rate is Moody's corporate Aaa rate; the real rate is the nominal rate less the three-year annual average change in the consumer price deflator.

Source: Federal Reserve Board and JEC Staff calculations.

So our macroeconomic policy mix between fiscal and monetary policy has affected not only our choice of how many resources we set aside for tomorrow, rather than devoting to gratification today, but also our choice of types of investments we make for our future. In every respect, our policy choice has had an adverse impact on our long-term standard of living.

Background: How Macroeconomic Policy Works

There is considerable controversy among economists about exactly how fiscal and monetary policy work, but a few basic points seem certain. First, increases in Federal spending add to total spending in the economy -- either because the Government buys goods and services directly or because its grants and benefit payments encourage private spending. In principle, private spending could fall (and private saving could increase) when the government spends more, leading to no net increase in total spending. This has not

happened during the past decade, however, and many researchers find that the weight of the evidence goes against this notion.

Because growth in government spending does add to total spending, it follows that expansionary fiscal policy can speed up how fast factories hum and workers find jobs. Over time, however, limits to the human and material resources in the economy are ultimately encountered -- as they appear to be today -- or at times spending is constrained to fight inflation -- as it was early in this decade. In such circumstances, the primary effect of fiscal policy is on the composition of spending. Growth in direct government purchases or in spending by the beneficiaries of government programs then displaces other uses of the Nation's production, or more imports are drawn in from abroad. The alternative uses of output that are squeezed to make room for Federal spending may be private consumer spending, private investment in machines and factories or in housing, or exports to foreign buyers. The way this displacement occurs may be the result of deliberate policy -- through lowering some types of government spending as others rise, or through adjusting taxes to discourage private spending (especially consumption) in the near term. Alternatively, market forces may be left to do the job, working through interest and exchange rates, as they have been through much of this decade.

When market forces are left to do the job of tailoring total spending to fit the limits on the economy, some combination of two adjustments will ultimately occur. One adjustment is for higher interest rates to crowd out business and housing investment. Alternatively, as we have experienced in recent years, high interest rates may attract foreign investment capital while supporting a higher exchange rate for the dollar, which in turn makes imports cheaper and discourages exports; so we incur a big trade deficit. Because higher Federal spending and lower taxes tend to spur private consumption, the market adjustments to such fiscal policy leave us with some combination of fewer houses, fewer tools and factories for our workers to use (that is, less private capital), and more foreign debts that must be paid in the future. Neither less private capital nor more foreign debt lays a very good foundation for the next generation (the foreign debt growth is probably the "less worse" alternative). Furthermore, as noted above, the composition of Federal spending has been biased away from public investment in recent years. Early in this decade, as the economy was caught in the grip of soaring inflation and sluggish productivity gains, the major policy concern was thought to be improving our potential for economic growth. Yet the policies chosen will ultimately hurt long-term growth.

Another fundamental fact of economic policy is that monetary policy is the primary long-term determinant of prices. The central bank broadly controls the amount of "money" that "chases" the goods that are produced--though what constitutes "money" is an intriguing question of definition that has been changing with rapid financial innovations. The balance between goods and money determines the price level; and the rate of growth of money and credit, relative to the growth of output, determines the rate of inflation. Monetary policy had its work cut out for it early in this decade. In 1980 and 1981, it moved decisively toward restraint.

It also seems obvious that when the central bank reins in the growth of money and credit, interest rates tend to be higher, and when they relax, rates are lower, at least for a while. Because many types of spending are affected by interest rates (home buying is an obvious example), monetary policy affects demand, and the utilization of resources, in the short run. With both fiscal and monetary policy influencing the demands on the economy from one year to the next, the interaction between these policies is important for achieving both short-term goals of high employment and low inflation and long-term objectives of growth and competitiveness.

As the economy recovered from the deep recession in 1982, both fiscal and monetary policy were, appropriately, highly expansionary. Subsequently, particularly from late 1983 through 1985, monetary policy moved on several occasions toward the brake, while the fiscal policy foot remained on the accelerator. The result, which has lingered for some time, has been higher interest rates and more financial stress than would be necessary otherwise. Moving toward an appropriate policy balance is a major challenge that remains before us.

FISCAL POLICY: WHERE ARE WE AND HOW DID WE GET HERE?

Fiscal policy over the past decade has been characterized by four key developments. First, Federal spending has continued to grow. Second, there have been major changes in tax laws. Third, the social consensus that the Federal budget should be near balance (at least in good times) evaporated, requiring that we now seriously reconsider the drain we are imposing on National saving. The fourth development, to be addressed primarily in Chapter IV, has been a fundamental change in the composition of spending.

Emergence of the Deficit

On the spending side of the budget, total Federal outlays rose at a rate of 8.5 percent per year over the decade from 1979 to 1989, while GNP rose at a 7.7 percent annual rate. Hence, outlays grew relative to GNP, from 20.6 percent of GNP in 1979 to 22.2 percent last year. This rise is the more striking because the

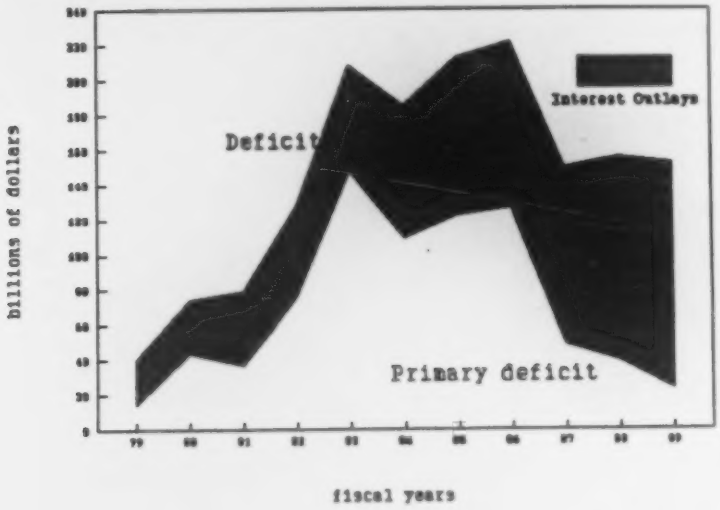
economy was in the general neighborhood of full employment in both of the years being compared. (The unemployment rate averaged 5.8 percent in 1979 and about 5.2 percent for the past year; in the interim, the aging of the baby boom and other factors, such as more favorable energy prices, have permitted a lower unemployment rate without pressure on inflation.)

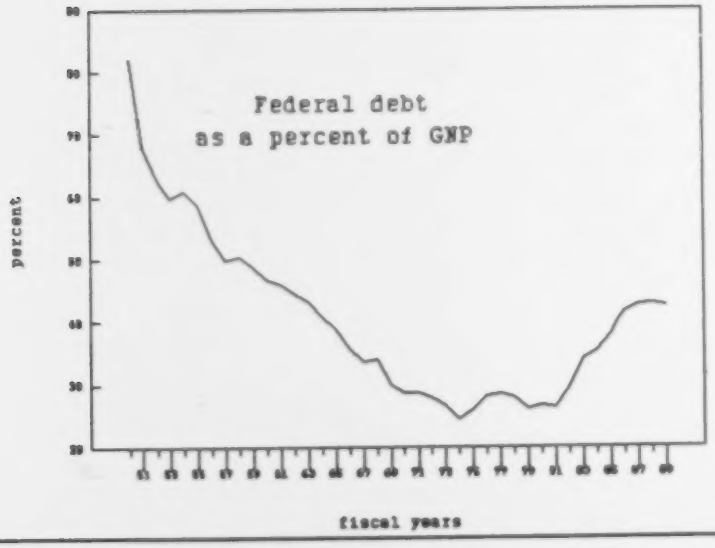
Meanwhile, on the income side of the budget, total receipts grew at a 7.9 percent rate, more than half a percentage point slower than outlays. While the ratio of total receipts to GNP (19 percent) has been virtually unchanged over the decade, the ratio for only those receipts other than the payroll taxes earmarked for the OASDI trust funds has fallen by one percentage point, from 15 percent to 14 percent.

The driving forces in the growth of expenditures are analyzed in Chapter IV, but one particular observation should be noted here: budget deficits feed on themselves. In FY79, the deficit was $40 billion, or 1.6 percent of GNP. Of that amount, $26 billion was attributable to interest on the debt (net of taxes paid on interest) while the rest of the deficit, sometimes called the "primary" deficit, was $14 billion. Most of the debt outstanding at that time had been built up during World War II. In 1989, net interest payments (after interest receipts and taxes) were much higher, at $129 billion, while the primary deficit was little increased, at $23 billion (see Figure II.2). The skyrocketing interest costs largely followed the Federal debt as more and more Treasury securities were issued during the 1980s to cover big gaps between spending and receipts. A sizable gap emerged during 1982-1983 because of the recession; it was not counterbalanced by subsequent surpluses during the following expansion and, therefore, left a large addition to debt in its wake. A lesson from this experience is that if we run continual deficits even in prosperity, a steep recession, which seriously cuts taxable income growth and adds to outlays, is likely permanently to ratchet up the burden of debt and interest costs in the budget.

Recession, however, was not the only source of the problem. Total receipts also tended to lag behind GNP and outlays in 1982-84 because of large income tax cuts coincident with a peak in defense appropriations. Some of the excesses of the 1981 Tax Act have been rectified, particularly by the Tax Reform Act of 1986, which rationalized the tax structure sufficiently to add 2.2 percentage points to the net national product over the long run, according to calculations by the Council of Economic Advisers. In view of the generally accepted gains from the Tax Reform Act, great care will be needed in any future legislation to preserve its good points and the fragile consensus upon which is rests. Nevertheless, there has been a yawning deficit gap and a much larger debt relative to GNP (see lower panel of Figure II.2). Continuation of the primary deficit at the 1989 level, and of interest rates and nominal GNP growth rates at roughly the levels of the past year, would lead the debt-to-GNP ratio to flatten out at about 50 percent -- back to the level of 1958, thus wiping out in one decade the progress of two decades in reducing the size of the Federal debt relative to U.S. production.

Figure II.2
Federal Deficit, Interest Outlays, and Debt





Source: Office of Management and Budget, U.S. Treasury, and JEC Staff calculations.

In the just-completed fiscal year, the Federal budget deficit was $152 billion. Although this outcome was a hair below the preceding year, and was less than the February estimates of Congressional Budget Office (CBO) and the Office of Management and Budget (OMB), it marked the third consecutive year in which the budget deficit has been stuck in the neighborhood of $150 billion. Table II.1 shows the extent to which the deficit has exceeded the targets in the Gramm-Rudman Act.

Table II.1
Federal Budget Deficits and Deficit Targets
(Total budget, in billions of dollars, by fiscal year)

	1987	1988	1989
Actual deficit	150	155	152
Gramm-Rudman Targets			
Original	144	108	72
Amended	--	144	136

Source: U.S. Treasury and Acts of Congress.

The Deficit in Perspective

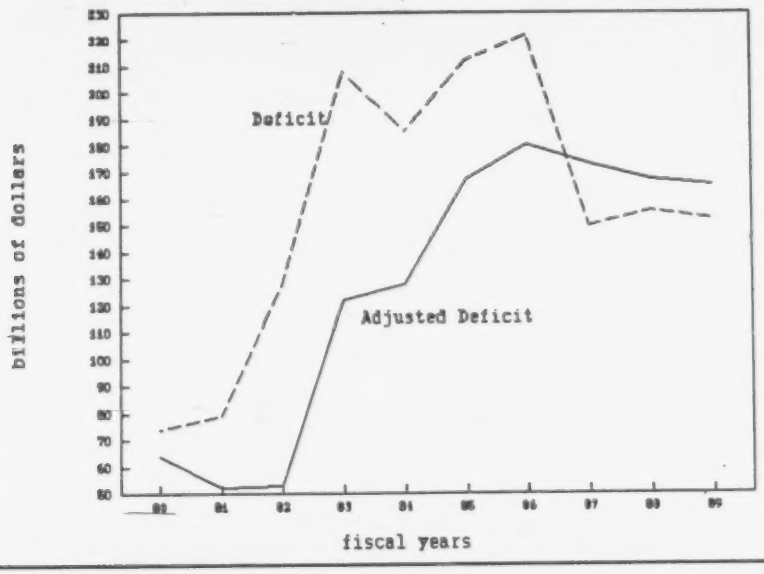
Because the economy has been expanding, the same number of deficit dollars is slightly less significant than in the past. The deficit as a percent of GNP has edged down from 3.4 percent in 1987 to 3.0 percent in 1989. Of course, policy makers can take only a part of the credit for that decline. Economic expansion itself helps to reduce the deficit, because tax receipts rise with the increase in taxable incomes and, to a much lesser extent, some benefit programs contract in relative size. For example, the deficit fell from $208 billion in FY83 to $185 billion in FY84, but budget policy was essentially unchanged. All of the improvement in the deficit was attributable to the recovery of income and the decline in unemployment in the first year and a half of cyclical recovery.

The budget numbers also have been confused by a number of transitory factors, including financial transactions (such as asset sales and the on-budget part of the Resolution Trust Corporation's outlays in 1989), timing adjustments (such as the shift of a military pay date from 1990 into 1989), and accounting devices (putting some spending off budget). Many of these measures have been undertaken only to meet the short-run Gramm-Rudman budget targets. In addition, both the phasing in of the various provisions of tax reform and the responses of investors to them caused sharp short-run movements of receipts. These gyrations confuse the picture of underlying budget developments.

The effects of timing games on the budget are short-lived, and economic growth cannot be counted on to bail us out of our budget problems to the extent that it has in recent years. Therefore, an adjusted deficit is shown in Figure II.3, with the effects of cyclical fluctuations, the Tax Act, and budget games factored out.

This adjusted deficit gives a better picture of the fundamental trend in budget policy. As indicated in Figure II.3, the underlying trend in the Federal budget deficit was up very sharply from a rather flat valley in the early years of the decade to a peak in 1986. Since then, after stripping away window dressing and smoothing through the effects of adjustment to tax reform, the deficit is shown to be on a new higher plateau.

Figure II.3
The Deficit in Perspective
(Total budget basis)



Source: Office of Management and Budget, U.S. Treasury, and JEC Staff calculations.

This high plateau is indicative of the political problem facing decisionmakers. No one wants a deficit this high; it entails economic costs and signals a paralysis in government decisionmaking. Yet, just keeping the deficit from growing has involved great pain. With no consensus about how to change spending priorities, there is a strong tendency to continue existing programs, though many have been preserved only in pared-down form. Although some programs assuredly deserved to be reduced -- indeed, there may still be programs that should be abolished or consolidated -- other significant areas of the budget have been underfunded (public infrastructure and the maintenance of justice, for example). In this environment, it is extremely difficult to find financing for new priorities, witness this year's delays in funding drug and crime control, aid to Eastern Europe, and disaster relief. Thus, the deficit is distorting our policies.

Costs of the Deficit

Most discussions of the budget focus on the total budget numbers kept by OMB, but the effects of the budget deficit on the economy may be usefully viewed by putting the Federal sector in the same accounting framework as the private sector. This is done in the National Income and Product Accounts (NIPA). Because this framework omits many of the transitory factors and financial asset exchanges that were excluded above to get the adjusted deficit (shown in Figure II.3), the Federal sector NIPA deficit moves similarly to the adjusted deficit (though some timing effects of tax reform remain.) As Table II.2 indicates, over the past three years, the NIPA deficit has averaged 3.2 percent of GNP; this exceeds the ratios in many recession years.

Table II.2
The Budget, GNP, and Saving
(Averages of fiscal years, NIPA basis)

	Deficit as a Percent of GNP			Deficit as a Percent of Saving [c]
Recessions [a]		High Employment Years [b]		High-Employment Years [b]
1960-61	0.4	1967-69	0.7	6.7
1970-71	1.0	1972-74	1.0	11.3
1975-76	3.2	1977-79	1.6	17.6
1982-83	4.7	1987-89	3.2	60.7

SOURCE: Bureau of Economic Analysis, U.S. Department of Commerce: National Income and Product Accounts, Table 5.1.

a. Average for the year containing recession trough and the next year.
b. Average for the three years before the next cyclical peak; most recent three years of the current expansion.
c. Saving is defined as net domestic saving before subtracting the Federal budget deficit; that is, personal plus corporate plus state and local government saving less economic depreciation..

Of greater significance than the ratio to GNP is the deficit's absorption of the Nation's savings (see the right column). The existence of a deficit means that the Federal sector is using directly, or is providing means for the private sector to consume, more resources than are being claimed through taxes. Thus the Federal sector is preempting a part of National output that otherwise would be available for private investment (domestic or foreign). Of course, if private saving is ample, it can finance government deficits without shortchanging private investment -- as is the case in Japan, for example. In the United States, however, when the Federal debt (which represents the accumulation over time of borrowing necessary to finance deficits) grows relative to GNP, private capital generally tends to decline relative to GNP. For several years now, private saving (together with saving done by the state and local sector) has been languishing. As a result, current Federal deficits and the associated buildup of debt are particularly hazardous to capital accumulation and

future prosperity -- that is, they threaten the growth of productivity and potential GNP discussed in Chapter I.

Deficits do damage by raising real interest rates and the foreign exchange value of the dollar, which then affect production and employment. As will be discussed below, budget deficits have complicated an already difficult situation for monetary policy over the past decade. Nevertheless, despite exceptionally high real interest rates in the 1980s (shown in Figure II.1), investment has not fallen back in step with the drain of the Federal deficit on National savings. To the extent that we have maintained investment, however, it has been necessary to draw financing from huge foreign capital inflows. These inflows give foreigners a claim on the profits from that investment, and may well be unsustainable (see Chapter III).

High deficits also have increased the riskiness of the environment. The large foreign capital flows and volatile exchange rates change foreign competitive pressures almost from day to day. This volatility greatly complicates business decisions regarding import and export contracts, and whether to locate plants here or abroad. The upward pressure on interest rates from deficits has exacerbated the rise in corporate debt-service burdens associated with mergers and leveraged buyouts. Whatever benefits these restructurings may have entailed in efficiency, they have added to risks of bankruptcies when recession strikes. And the obvious difficulties of the government in financing new priorities, threatening existing programs, and contemplating tax increases also has raised uncertainties. All of these risks and uncertainties tend to bias business strategies toward short-term payoffs, possibly at the expense of longer-term gains, as discussed by witnesses at recent Committee hearings.

A fiscal policy that feeds such a short-term focus is ironic when demographic changes require planning for the future. The coming increase in the number of dependent elderly relative to the number of employed demands equipping that workforce with the best education, training, and capital. Thus, demographic trends accentuate the reasons for a fiscal policy of narrowed budget deficits.

The Challenge of Fiscal Restraint

Reducing the budget deficit will tend to restrain total spending in the economy in the short run. Indeed, that restraint has begun, as the deficit has flattened out. Last year, restraint resulted mainly from slowing defense spending. (The stimulus or restraint coming from the budget results from explicit policies to speed up or slow down spending, such as defense or Medicare, or to change tax laws; it is roughly indicated by the movement in the adjusted deficit shown in Figure II.3). For the present, with unemployment fairly low and factory utilization fairly high, this restraint has been timely. Further restraint would correct our fiscal balance and allow interest rates to decline further, but the active support of monetary policy probably would be required to prevent the economy from slowing too much.

MONETARY POLICY: THE BALANCING WHEEL

Monetary policy has borne an extraordinary weight over the past decade. Much of the pressure came from the inflation that gripped the economy at the end of the 1970s, as shocks to energy prices compounded upon each other. The financial market implications of financing the budget deficit only added to these difficulties.

In 1979-80, the Federal Reserve System, the Nation's central bank, assigned top priority to wringing out inflation and restoring confidence in the dollar. To implement its anti-inflation policy, the Fed announced binding targets for the rate of growth of the money supply; interest rates would move to market-determined levels. (Most interest rates already had risen sharply as lenders protected themselves from repayment in depreciated dollars, and borrowers expected to be bailed out by nominal income increases.) Because of inflation-driven demands for money and credit and the introduction of new and attractive financial instruments, the rate of growth of money remained high through much of the 1980s and disguised the monetary restraint early in the decade. The Fed's tightened supply of bank reserves is indicated, however, by the rise in bank borrowing from the Federal Reserve's discount window (see second column of Table II.3) and the high levels of the discount rate and the overnight interest rate on borrowed reserves in the Federal funds market (see the last two columns of the table).

By 1982, consumer price inflation was down to the 4.5 percent range; however, this had been achieved at an enormous cost in terms of unemployment. This experience underscores that monetary restraint cannot curb inflation without pushing interest and unemployment rates up in the short run. It certainly suggests the serious costs of uprooting an entrenched inflation.

With unemployment rising and the rate of inflation falling substantially in late 1981 and 1982, the Federal Reserve let up on its restraint. This easing, together with substantial fiscal stimulus (the sharp rise in budget deficits mentioned earlier), propelled the strong expansion. Since then, monetary policy has "leaned against the wind." It has tightened a bit, raising short-term rates, when the pace of economic expansion has been rapid and inflation seemed threatening -- most notably in late 1983 and the first half of 1984, and through much of 1988 and early 1989. It has eased, reducing short-term rates, when the economy slowed and inflation ebbed -- most notably in 1986, briefly late in 1987 after the stock market crash, and since late Spring of this year.

Table II.3
Indicators of Monetary Policy

	M2 Growth[a]	Borrowing at Discount Window[b]	Discount Rate[c]	Federal Funds Rate[c]
1978	8.0	868	9.08	9.58
1979	8.0	1473	11.92	13.58
1980	8.9	1687	11.78	15.85
1981	10.0	488	13.04	13.59
1982	8.8	448	9.25	9.28
1983	11.8	772	8.73	9.43
1984	8.3	582	8.50	9.27
1985	8.5	819	7.50	8.10
1986	9.5	524	5.50	6.27
1987	3.5	294	6.00	6.92
1988	5.5	472	6.50	8.46
1989				
1st half	1.2(Dec. to June)	573(June)	7.00(QII)	9.73(QII)
3rd quarter	8.9(June to Oct.)	534(Oct.)	7.00(latest)	8-1/2(latest)

SOURCE: Board of Governors of the Federal Reserve System.

a. December to December, in percent.
b. December; in millions of dollars. Adjustment plus seasonal borrowing; excludes extended credit.
c. Fourth quarter average, in percent.

The Federal Reserve's intentions sometimes have been difficult to read from market data this year because of erratic bank behavior. However, a shift of direction is confirmed in the Records of Policy Actions of the Federal Open Market Committee (sometimes called the "directives"). This source is not very current because the directives are not released until after the FOMC meeting following the one in which the action is taken. More recently, some ease is suggested by the preponderance of market actions by the Fed (to drain or supply reserves). These sources make clear, however, that the Fed is balancing signs of weakness in the economy against the potential for inflation pressures that might emerge from the present low level of unemployment. It remains quite uncertain whether the Fed is willing to see short-term interest rates fall further.

Despite the overall downtrend in short-term interest rates since 1982 (shown in the table), longer-term rates, which are more important for investment activities, tended to remain relatively high through much of the expansion (see Figure II.1). This stickiness reflected a number of factors: the uncertainties in financial markets caused by the previous inflation; the new degree of volatility in foreign exchange markets; and the unprecedented budget deficits. Only in 1986 did long-term rates come down decisively, and they remained high relative to short-term rates until early in 1988. Since mid-1989, these rates have eased roughly in step with each other

because the economy was softening. Nevertheless, in both nominal and inflation-adjusted terms, long-term interest rates are still substantially above their levels in the more tranquil times of the 1960s. The soaring interest rates early in the 1980s set the stage for the decade to come. They hurt debt-intensive sectors (such as housing and agriculture), depository institutions that had trouble keeping deposits when the market offered lucrative alternatives (a factor in some of the subsequent savings and loan problems), and developing countries that were borrowing dollars. And to some degree they probably discouraged the investment in business plant and equipment that is important for future productivity.

Internationally, high U.S. interest rates and a large trade deficit were associated with volatile foreign exchange rates. These movements placed additional, and sometimes conflicting, pressures on the Federal Reserve. Lower interest rates would help to bring the dollar down and to narrow the trade deficit (by making exports cheaper for foreign buyers and imports more expensive at home). But a falling dollar also would increase inflation (because imports would be more expensive). Furthermore, there is a danger that foreign lenders may become satiated with U.S. bonds and loans, and fearful of renewed U.S. inflation; they would then slow their purchases of dollars, and drive the dollar over a cliff. In such an event, the reaction of financial markets and, probably, the policy response of the Federal Reserve would push interest rates much higher once again, possibly threatening the economic expansion. Thus, the combination of policies that has evolved over the 1980s creates substantial instabilities and risks.

CONCLUSION

Macroeconomic policies have brought us to lower unemployment rates and lower inflation rates than we have experienced in a long time. However, they leave us with major imbalances in the economy -- most notably the unprecedented budget and trade deficits. Because these problems are interrelated, they must be addressed jointly. We must cut the Federal budget deficit, which will reduce the drain on private domestic saving; we need permanent deficit reduction consistent with the fundamental priorities for our society. The nature of the choices that this will require is discussed in detail in Chapter IV. A further requirement is for monetary policy to respond in a coordinated fashion to the fiscal restraint of deficit reduction. The appropriate response will depend on other developments in the world economy. Simple policy rules are not likely to be adequate. But careful policy coordination can contribute to lower trade as well as budget deficits with relatively stable unemployment and inflation.

CHAPTER III. THE UNITED STATES IN THE WORLD ECONOMY

During the 1980s, the U.S. economy became more open, and lost its traditional imperviousness to economic events beyond our borders.

This opening was driven by two negative developments -- a collapse of exports and a surge of imports -- which together produced our worst recorded external payments deficit. This greatly strained our traded-goods sector. However, there was little negative impact on the overall economy, which was protected by a large inflow of foreign capital. Foreigners lent us the funds we needed to consume more than we produced -- to live beyond our means.

Few responsible analysts believe that we can continue indefinitely along this path. Eventually, the United States must bring its external accounts back to stability. The longer we delay, the more difficult it will become, because our growing foreign debt entails a rising annual outflow of payments of interest and dividends.

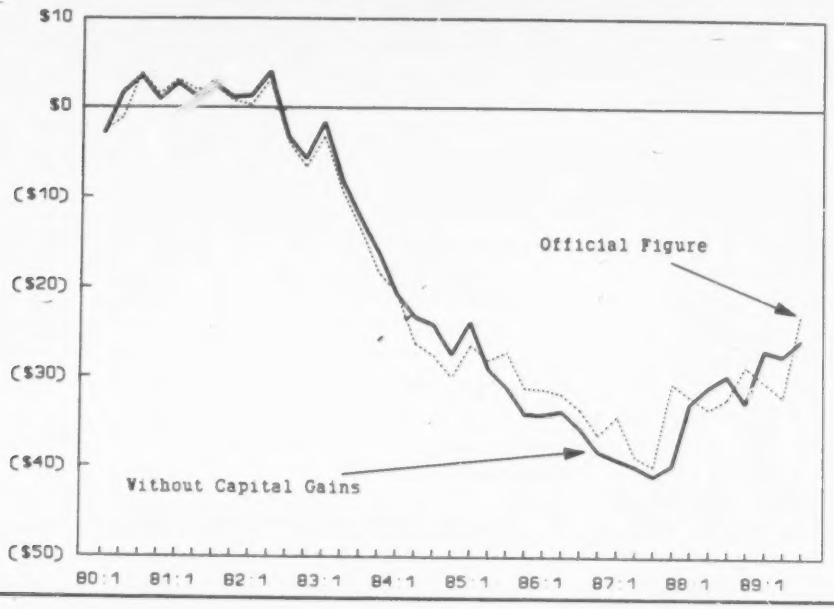
OUR INTERNATIONAL BALANCE IN THE 1980s

Figure III.1 shows that the U.S. current account, the broadest measure of our external balance, deteriorated sharply during the early 1980s, recovered rapidly but only partially by mid-1988, and then has remained essential unchanged. Several factors contributed. First, a restrictive U.S. monetary policy, combined with (and partially compensating for) a loose fiscal policy, drove up U.S. interest rates relative to those abroad. This interest rate differential helped attract foreign capital, which drove the dollar to record highs against other currencies. The overvalued dollar caused import prices to fall and export prices to rise, stimulating imports and penalizing exports.

Second, the large U.S. budget deficit drained national savings while household and business savings were also falling. The shrinking pool of savings was too small to finance prior levels of investment, producing a macroeconomic imbalance where consumption and investment were larger than production. In a closed economy, interest rates would have risen until they had discouraged, or "crowded out," private investment, to the point where investment was equal to savings. Instead, the open U.S. economy attracted foreign savings to make up for our own shortfall. But this meant that exports and products in competition with imports were "crowded out" by the high dollar rather than investment being "crowded out" by low domestic savings.

Third, the U.S. expansion early in the 1980s was a stark contrast to the rest of the world, where fiscal austerity was practiced, not merely preached. Budget reductions in both Europe and Japan depressed their economic growth, while our deficits took our economy in the opposite direction. The growth differential between the U.S. and foreign economies also increased our consumption of their exports, and depressed their consumption of ours.

Figure III.1
U.S. Current Account Deficit
(Billions of dollars, quarterly data at annual rates)



Source: National Income and Product Accounts.

Fourth, other major economies were substantially less open to imports than was the U.S. economy. Whether through law or custom or market structure, many foreign economies found ways to limit imports while expanding exports. The resulting trade surpluses of countries such as Germany, Japan, Taiwan and Korea contributed significantly to global economic imbalances.

Fifth, U.S. export markets in the Third World collapsed, particularly in the heavily indebted middle-income countries of Latin America. The "debt crisis" forced countries to slash imports and boost exports. Latin America is considerably more important to U.S. trade than to the trade of other major economies, and when debt-crisis austerity hit, it was U.S. exports which suffered, and U.S. markets which were targeted for Third World exports.

Finally, some of the deterioration in U.S. trade resulted from a loss of technological and marketing "competitiveness" by U.S. firms. Throughout the 1980s, the U.S. invested a smaller share of GNP than many of our competitors, particularly in civilian research and development. Lagging investment helped deprive the U.S. of its technological edge in semiconductors, machine tools, robotics, autos, steel, and other products.

Further, firms in many other trading countries had for years been forced to export or stagnate. Their biggest target was the U.S. market, the largest in the world. U.S. firms, on the other hand, could be content with the home market. This historical difference in experience gave foreign firms an edge in international marketing.

All of these factors combined to erode U.S. external trade, and all must be corrected for the U.S. to balance its external accounts. There is no single explanation and no single solution for the problem.

THE OUTLOOK FOR THE 1990s

Since 1986, the U.S. international position has improved markedly. The dollar has fallen to a more sustainable level, and hence, exports have grown much more rapidly than imports. Many believe that the international trade problem is behind us.

Such optimism is premature. Our merchandise trade improvement has slowed during the past year, while our annual payment obligations on our growing net external debt have increased. Unless there is a shift in policy and performance, our external position is unlikely to improve further.

Merchandise Trade

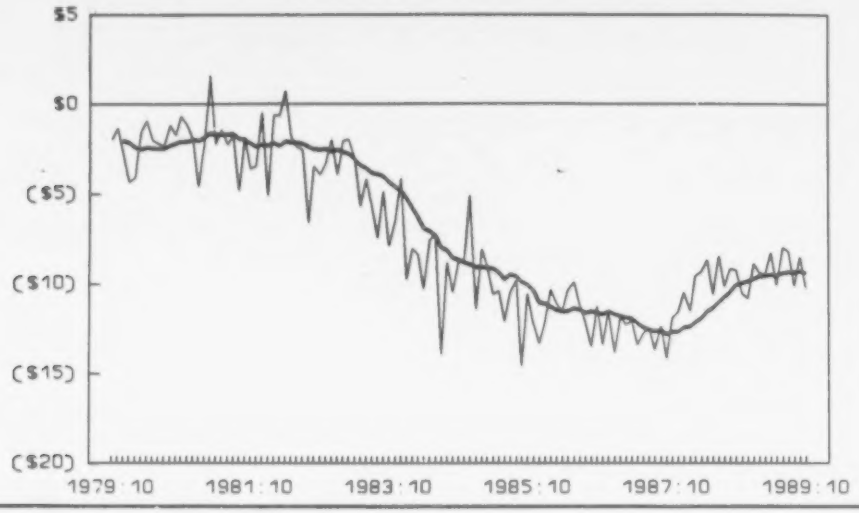
Merchandise trade is the largest part of our external balance. Figure III.2 shows that our merchandise trade account deteriorated rapidly during the early 1980s, and then improved in 1987 and 1988. But improvement slowed during 1989.

An important part of the merchandise trade story is the dollar. The dollar rose sharply through the early 1980s, then fell equally sharply from 1985 through 1987. In 1988 the dollar was roughly stable, but in 1989 it rose yet again. Merchandise trade's improvement in 1987 began two years after the dollar had peaked. That two-year lag suggests that much of the improvement in U.S. trade owing to the change in the dollar between 1985 and 1987 is now over, and that we should soon begin to see the ill effects of the stable and rising dollar of 1988 and 1989.

Investment Flows

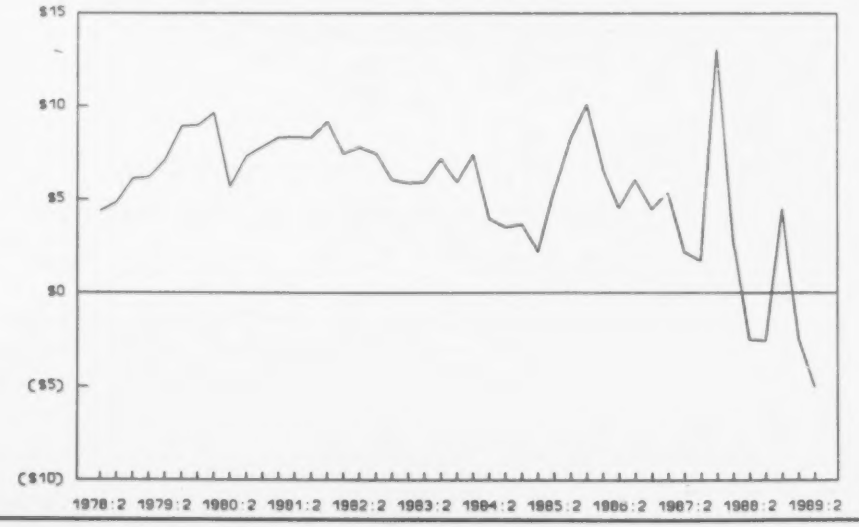
In addition to receipts and payments for merchandise imports and exports, the U.S. external payments position also includes earnings of U.S. firms on assets held abroad and payments to foreign investors on their assets held in the United States. Figure III.3 shows that the longstanding U.S. surplus on investment income transactions has been replaced by a growing deficit. The quarter-by-quarter data fluctuate with the exchange rates, but the trend is unfavorable.

Figure III.2
U.S. Merchandise Trade Deficit
(Billions of dollars, monthly data and 5-month moving average)



Source: Department of Commerce, Bureau of the Census.

Figure III.3
U.S. Net Investment Income
(Billions of dollars, quarterly data, seasonally adjusted)

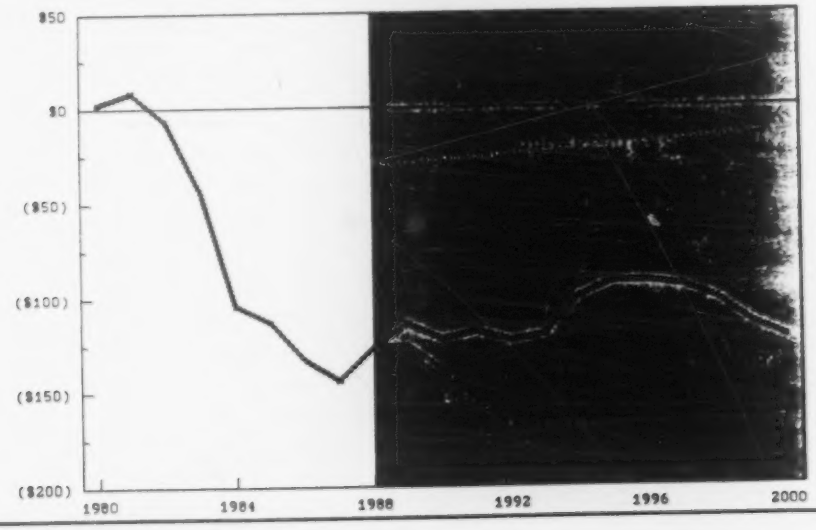


Source: Department of Commerce, Bureau of Economic Analysis.

The reason is that each year's current account deficit adds to the accumulated foreign debt. We cannot consume more than we produce unless foreign savers lend us the difference, or buy our assets to provide the necessary cash. These capital inflows can be direct investment in plant and equipment, purchase of equities, real estate, or bonds, or bank deposits. Whatever the form, these inflows add to the stock of assets in the United States controlled by foreign investors, and thereby add to the annual stream of dividend and interest payments owed to foreigners. These payments erode the U.S. current account. The U.S. can stabilize the current account only by improving the merchandise trade balance in equal measure to the increase in net dividend and interest payments to foreigners. Improving the current account will require merchandise-balance improvements greater than investment-balance deterioration.

Figure III.4 presents two recent forecasts for the U.S. current account. Data Resources, Incorporated, forecasts a slight improvement in the next few years, stabilization at roughly $100 billion per year, and then further deterioration. The IMF staff in October of 1989 projected a deterioration of the U.S. current account in 1989 and 1990. Neither forecast calls for enough improvement in the merchandise trade position to compensate for the deterioration of net investment income.

Figure III.4
U.S. Current Account Balance
(In billions of dollars)

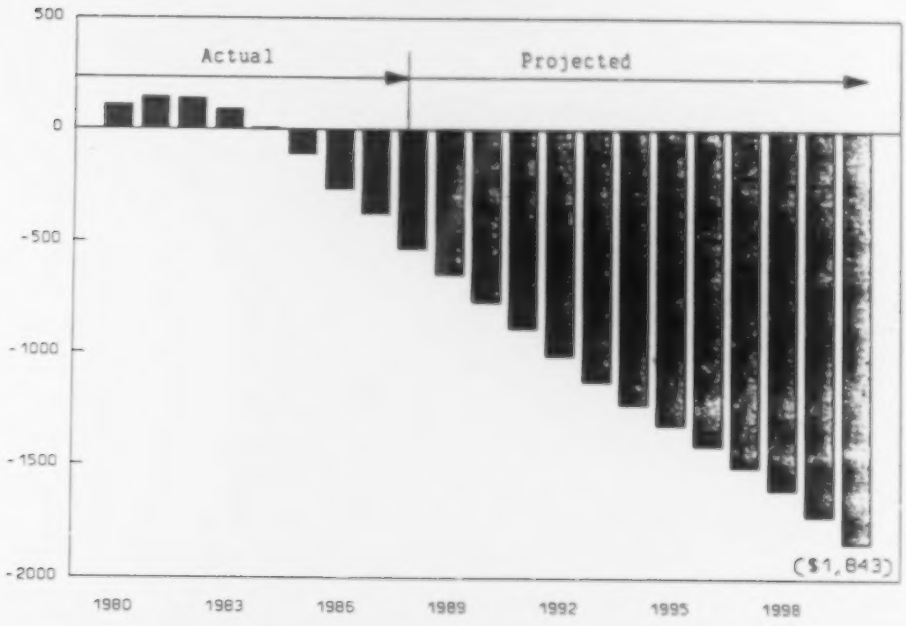


Source: Data Resources, Inc.; International Monetary Fund.

> The Treasury Department agreed, in its October report to Congress:
> On balance, it would appear that further improvement in the U.S. current account position in 1990, if any is to occur at all, is likely at best to be very modest. Furthermore, the possibility of deterioration in the current account next year cannot be excluded.

Figure III.5 shows that the net external debt would reach nearly $2 trillion by the end of the century if the DRI forecast materializes. The growing annual interest and dividend payments on this growing net external debt perpetuate the debt itself.

Figure III.5
U.S. Net External Asset Position
(In billions of dollars)



Source: Data Resources, Inc.

RESTORING THE U.S. INTERNATIONAL POSITION IN THE 1990s

The erosion of our international economic position is a major threat to both our future prosperity and our influence in world affairs. We must service our external debts out of future production, at the expense of future living standards. And as the world's largest debtor Nation, we will have increasing difficulty persuading our creditors to accept our leadership -- which has been a cornerstone of international stability.

America's deteriorating international position is not a problem for the United States alone. Our huge deficits have fueled an unprecedented growth in world financial imbalances, which pose a serious threat to continued world economic growth. As the staff of the IMF noted in their recently released *World Economic Outlook*:

> The prospect of large and persistent payments imbalances has raised a number of concerns. First, concern has been expressed about sustainability, in the sense that persistent surpluses and deficits might lead to an explosive spiral of rising interest payments and growing external asset and liability positions. Second, even if the stocks of external assets and liabilities tended to stabilize over time in relation to GNP, the continuation of large imbalances eventually might give rise to disruptive market reactions and exchange rate swings. Third, assuming that adjustment could take place without causing turbulence in financial markets, it could have certain undesirable consequences where the industrial countries are operating at high levels of resource utilization. Fourth, large trade imbalances -- no matter how unjustified -- tend to generate pressures to restrict imports and limit foreign investment.
>
> These concerns support the view that large payments imbalances constitute an element of vulnerability for the world economy, and that external adjustment should be an important objective of macroeconomic policy.

While the rhetoric of the IMF is modest and deliberate, its analysis suggests that worldwide market crashes, inflation, and currency instability are all potential legacies of U.S. mismanagement of its external economic situation.

CORRECTING THE EXTERNAL IMBALANCE

The U.S. merchandise trade and current account deficits cannot continue at their present levels. We need to return the merchandise trade account to balance within five years just to rein in the large and growing annual current account deficit (which would continue because of net interest payments).

Reaching trade balance will be difficult and painful. We must change not only our own practices, but also those of other nations, and of the international trade and financial systems.

Specific Steps

Reduce the domestic savings-investment imbalance. The shortfall of domestic savings below the rate of domestic investment is a key cause of our international imbalance. Eliminating the savings shortfall would, by definition, eliminate the deficit in the current account.

We could eliminate the shortfall simply by cutting the Government deficit and raising private savings. This is "adjustment through austerity," which the IMF has traditionally required for heavily indebted countries. But the lesson of the 1980s in the developing world is that adjustment through austerity corrects external imbalances only at the cost of recession. Typically, a rapid move toward budget surplus and rising private savings slows the economy and reduces domestic investment. Rising savings and

falling investment ends the external imbalance, but at a permanent cost to investment and growth.

Adjustment through austerity is painful for the adjusting economy, but in the case of the United States, it would also harm other nations. Our recessions generally have triggered recessions elsewhere, simply because of the size of our economy. Yet since the last world-wide recession, the United States has become an even more important market for other nations, and so a U.S. recession in the future might be even more damaging to the world economy.

Therefore, we must reduce our savings shortfall gradually and maintain growth in demand sufficient to sustain private investment. This will require a different mix of fiscal and monetary policy. The U.S. external imbalance was caused by a combination of loose fiscal policy and tight monetary policy, and we need the exact opposite. A tighter fiscal policy would slow consumption and raise national savings, reducing the need for foreign capital and thus allowing a looser monetary policy -- which would itself lower interest rates and stimulate investment. The key is to reduce the budget deficit, because a tighter monetary policy, though it also could clearly slow the growth of consumption through higher interest rates, would raise the value of the dollar and the costs of servicing our net external debt, thus undoing much of the good done by increasing savings.

Refocus public spending priorities on investment. Cutting our merchandise trade deficit will require more -- and more efficient -- capacity in our exporting and import-competing industries. Sustaining investment in the private sector will require complementary action in the public sector, as was documented in Chapter 1. Projected cuts in real defense spending in particular should free up resources of skilled labor and equipment for use in export industries.

Achieve an appropriate exchange rate for the dollar. The 1980s show that U.S. exports are responsive to the exchange rate of the dollar. Improvement in our trade position therefore requires policies that maintain a competitive exchange rate for the dollar. Recent events raise questions about our policies.

The fundamental step is to eliminate our shortage of savings relative to investment. Also needed are coordination internally -- between the Treasury and the Federal Reserve -- and cooperation externally -- between the United States and other major trading countries. Only when these conditions are met can the authorities achieve a target for exchange rates.

The case for internal coordination can be made with a brief review of dollar policy during the 1980s. Early in the decade, the dollar was ignored. The Fed pursued disinflation through a very tight monetary policy, while fiscal policy pumped up demand with large deficits. The collision between these two forces drove the dollar up, crippling American manufacturing firms and choking investment in the manufacturing sector.

By 1985, the costs of this neglect of the value of the currency forced a coordinated move to bring the dollar down. This time, policies moved together instead of in opposite directions. Fiscal policy became tighter, while the monetary authorities tolerated a drop of interest rates of nearly half between the end of 1984 and the end of 1986. The G-7 Nations (the United States, Great Britain, France, West Germany,

Japan, Italy, and Canada) and their central banks cooperated. The dollar retraced nearly all of its previous rise, stabilizing in 1987 roughly 5 percent higher than its previous low. Rarely have announced international economic policies been so successful. But then the underlying agreements which propelled this decline began to fall apart; U.S. deficit reduction stalled, and the Fed turned to controlling incipient inflation. Interest rates began to climb again, and as the rates went, so went the dollar. From the end of 1987 to the fall of 1989, the dollar rose by more than 11 percent against a trade-weighted basket of foreign currencies.

The dollar rose in spite of a commitment from the G-7 Nations to stabilize the major currencies at their 1987 levels. There were massive coordinated interventions of the world's major central banks to drive down the value of the dollar. There was momentary success, but most market participants believed that they would have little lasting impact without a U.S. commitment to a tighter fiscal policy and a looser monetary restraint.

Encourage surplus countries to strengthen internal demand and open domestic markets. Reducing the U.S. external imbalance without a recession will be difficult without compensating changes by the major surplus nations. The U.S. must continue to press Japan, West Germany and the Asian newly industrializing countries to maintain growth, shift demand from exports to domestic consumption, and eliminate barriers to imports.

During the 1980s, surpluses were as great a problem for the international economic system as deficits. Deficit countries raised the global risk of inflation through excessive demand, while surplus countries raised the global risk of recession by expanding output faster than demand. While the international financial system provided orderly finance for the imbalances, continued world economic stability requires prompt and orderly reduction of surpluses and deficits. The best path to surplus reduction varies by country, and we should consider these differences in negotiating reduction of the surpluses.

West Germany has regulations and subsidies, as well as trade barriers, that keep unemployment high and domestic demand low and thus encourage the export sector. The newly industrializing surplus countries of Asia have manipulated exchange rates, imposed formal barriers to imports, and held down wages and domestic demand. Progress has been made on several of these issues, but more remains to be done. The roots of Japan's surplus lie not in macroeconomic policy but in the structure of the Japanese market. There is growing international recognition that both policy and custom have combined to produce a domestic market relatively closed to imports from abroad. A recent Joint Economic Committee hearing documented the relatively closed nature of the Japanese market. Particularly significant was the work by Robert V. Lawrence of the Brookings Institution, which found that prices in Japan for goods which were traded internationally were substantially higher than the prices for the same goods in other major markets, even after adjustment for Japan's inefficient distribution system. Such price discrimination is strong evidence of a closed market in Japan which both penalizes Japanese consumers and contributes to large Japanese external surpluses.

Reduce anti-competitive burdens on industry. Finally, we must reduce anti-competitive burdens on American firms. A variety of U.S. regulations reduce the ability of American firms to export into foreign markets. Considerable progress has been made on modernizing U.S. antitrust law to take account of the realities of international competition. Recent changes in antitrust law have helped clear the way for increased technological cooperation among U.S. firms. Export controls are another area ripe for change; there may be valid arguments for withholding certain types of technology even with the reduction of tensions with the Soviet Union, but western security interests are also served by facilitating economic reform in the East.

Finally, U.S. businesses pay directly some 25 percent of the Nation's health-care costs bill through medical insurance premiums for their employees. These health-care costs become embedded in the price of U.S. goods, and international comparisons show that U.S. health care costs are higher and rising faster than those of any other major country. Chrysler estimates that it spends $700 per vehicle on health care, while Canadian car makers pay only $223, Japanese firms $246, French companies $375, and West German firms $337. A January survey of 9,000 small companies by the National Association of Manufacturers cited health costs as the "greatest threat to their economic vitality and ability to compete." The solution is uncertain, but many firms appear willing to support a universal system that would control health costs, extend coverage to all Americans, and reduce the proportion of health costs that become embedded in the prices of American exports.

THE DIPLOMATIC FRONT: IMPROVING THE WORKINGS OF THE WORLD ECONOMY

The U.S. has an important self interest in reducing its external deficit. But the U.S. also has a stake in the international economic system. The U.S. was the principal architect of the Bretton Woods system which emerged after World War II, and this system now faces two fundamental challenges.

The first challenge is to the world financial system, which must manage huge capital flows and resolve such difficult problems as Third World debt and the financing of economic reform in the centrally planned economies. The second challenge is to the rules of the game in the international trading system, where rising non-tariff barriers and various bilateral and multilateral initiatives may break the open world trading system into a set of regional or bilateral special relationships. As world leaders, we must seek solutions in both of these areas.

CHALLENGES TO THE FINANCIAL SYSTEM

The 1980s global trade imbalances grew just as governments around the world de-regulated their financial sectors. Without these financial innovations, restrictions on capital mobility probably would have choked off the huge trade imbalances. But the enormous growth of international finance brings problems of its own. In 1988, total world trade amounted to some $2.7 trillion. In that same year, a New York Federal Reserve Bank study found that the daily exchange of one currency for another amounted to some $500 billion. Thus the total world import bill for a year could be covered by a week's worth of currency trading. This enormous and growing

international capital flow has changed the very foundations of the international financial system, calling into question many national and international financial practices. It is time for imagination on at least the following four topics.

Improving international supervision and regulation of financial markets: Traditionally, all countries have recognized that "finance" has unique importance and must be supervised and regulated by public authorities. The United States during the 1980s did, however, abandon much of its traditional structure of financial regulation. Regulations were abolished and regulatory staffs were cut as financial institutions were allowed unprecedented freedom. Financial regulators elsewhere in the world were less radical in de-regulation, but all acknowledge that regulatory systems based on national laws and traditions are inadequate for safeguarding the integrity of the new internationalized financial system. The global financial system will require some sort of global supervisory regime to maintain stability, preserve safety and soundness, and insure that the system channels savings to productive uses.

Initial steps toward such a system have already been taken in the commercial banking sector, through the Basle agreements on capital adequacy standards for commercial banks; but progress in other areas of international financial regulation has been slow. A more ambitious agenda might include capital standards for non-bank financial institutions, disclosure requirements based on common accounting principles, and common rules against unfair practices such as insider trading.

The need for such measures has been underscored by the recent volatility in international stock markets, which now appear to be closely linked to each other. Financial shocks originating in one nation's securities markets now quickly spread throughout the world.

Defining the mandate of international financial institutions: The extraordinary expansion of private international capital flows has clearly undermined the traditional roles of key multilateral financial institutions--the World Bank and the International Monetary Fund. In the original Bretton Woods system, the Bank was to provide long-term development assistance to countries in need, while the IMF was to provide short-term balance of payments support to countries with temporary current account deficits. Between 1950 and 1970, both institutions generally performed according to their initial mandates, but in the 1970s and 1980s, other institutions took over many of the functions of both the Bank and the Fund. Commercial banks provided balance-of-payments lending to developing countries during the 1970s, while global securities markets in the 1980s financed the balance-of-payments deficits of major industrial countries. In both the British and American balance-of-payments difficulties of 1976 and 1978, the IMF played an important lending role, but these were the last times the Fund was called upon to facilitate trade adjustment in the industrial world.

When commercial banks stopped lending to developing countries in the "debt crisis" of the 1980s, the World Bank and the IMF turned their energies toward this problem. The Fund was constrained by its structure and financing to provide only short-term financial support, though the debt problem required long-term solutions.

This created two problems: First, the Fund tried to push debtor countries into stabilization programs which had large short-run payoffs. Such programs generally involved inducing domestic recessions to boost the trade balance, and these recessions sapped the will of debtors to carry through with reforms. Second, the short-term Fund lending created financial problems for borrowing countries. Many could not mobilize the resources to repay IMF principal, leading to a marked increase in arrears to the Fund. Others managed with difficulty to repay the fund, but these outflows reduced the funds available to support adjustment. Over the past few years, the Fund has become a net taker of resources from poor countries.

With both the Bank and the Fund focused on the problems of Third World debt, it appears to many that the two institutions have lost their distinct mandates. This is likely to be the focus of debate if, as anticipated, the U.S. Treasury agrees to international calls for a substantial increase in IMF quotas. With both institutions now focused on structural adjustment in the Third Word, the Bank's ability to invest and plan over the long term gives it an advantage. The logical case for continued Fund involvement turns around its unique ability to create reserves for Third World central banks through the issuance of Special Drawing Rights. There has, however, not been a new issuance of S.D.R.s since 1978, largely because a few major countries have opposed such a move as inflationary. While there is no global need for more bank reserves, there is a reserve shortage in debt-problem countries. An expanded S.D.R. allocation directed for countries unable to finance reserves through trade or borrowing now has significant intellectual support.

Resolving the international debt crisis: The orderly reduction of world imbalances is likely to require resumption of growth among the heavily-indebted countries of the Third World. Concerns about the "overhang" of debt in these countries are presently blocking the flow of needed funds, and eliminating this debt blockage is a critical task for restoring health to the world financial system.

Throughout most of the 1980s, global debt strategy has involved severe adjustment policies in debtor countries, aimed at cutting demand and boosting exports, and involuntary lending from commercial banks to provide minimal financing to meet interest payments on external debts. As the crisis has dragged on, it has become clear that commercial banks are unwilling to supply adequate new finance to sustain economic adjustment, and the policy focus has therefore turned from involuntary lending to debt reduction. The "Brady Plan" for debt reduction has produced tentative financing packages for three countries – Mexico, the Philippines and Costa Rica – but details have not been worked out, and there are signs that commercial bank resistance may be undermining the Brady Plan much as it did the Baker Plan.

Of the three cases, the most important – and most problematic – is Mexico. After long and difficult negotiations, Mexico and its bank creditors agreed to less relief than originally desired, and made the improvement dependent on the availability of new money – the same old "new money" engine which failed to operate in the Baker Plan. Press reports strongly suggest that banks are unwilling to provide new money to augment debt reduction. Most U.S. commercial banks recently increased their reserves against losses on Third World loans, which is generally believed to make banks reluctant to lend new money to debtor countries.

Mixing new money and debt reduction in a single package appears to be particularly difficult. Significantly, neither the Philippines nor the Costa Rican packages attempted this mix. The Philippines package was overwhelmingly a "new money" deal, while Costa Rica was entirely a debt reduction package. If the lesson of the Mexico negotiations is that new money and debt reduction cannot easily be combined, then the international financial system must face a watershed decision: if it decides to go forward with debt reduction, then it will need to offer much deeper discounts to solve the problem. Alternatively, if new money is the desired route, then mechanisms will be needed to persuade banks to lend even after their recent decision to increase loan loss reserves.

Financing reform in the centrally planned economies: An historic opportunity is unfolding in the centrally-planned economies of the Soviet Union, Eastern Europe and China. The West must encourage market reforms and political liberalization. But reform will create painful adjustment burdens and strain the already fragile political consensus, and both the financial and trading systems. The heart of the problem is prices and currency convertability. Reform requires the introduction of price signalling to closed economies. Freeing prices, however, creates enormous risks of inflation, given the large volumes of local currencies in circulation and the short supply of high-quality local goods in the East. This creates the central dilemma: either slow the pace of reform and refrain from introducing genuine prices, or find some way of meeting the demand for goods which will be created through price reform. The first course jeopardizes market reform, while the second is likely to require a large flow of goods and money from the West. New York financial expert George Soros estimates that sustainable price reform in the Soviet Union could require as much as $25 billion per year in western finance. The United States should weigh its priorities against this historic opportunity.

CHALLENGES TO THE TRADING SYSTEM

Just as the world financial system is in the midst of historic change, so too is the world trading system. The GATT achieved some notable successes in the 1960s and 1970s in reducing high national tariffs and thereby expanding world trade. But many countries still sought advantages for domestic industries in other, non-tariff areas. National subsidies, multi-national agreements on commodities such as coffee and textiles, and bilateral or unilateral compacts governing such products as automobiles and steel all were new mechanisms for distorting trade. There are risks, in the extreme, of intensified protectionism, and a breakdown of the world trading system into more restrictive regional trading arrangements. U.S. trade diplomacy should head off these dangers.

Developments in Europe bear watching. While policy changes inside the European Community appear to be removing barriers to commerce, this internal liberalization should not be matched by increased discrimination against those outside the region. Some analysts have expressed concern; according to David Henderson, Chief Economist at the OECD, EC trade policy "has adopted discrimination as a norm, a guiding principle. One of the main constituent elements of a liberal trading system has thus been explicitly set aside." Elsewhere, Japan is increasing its investment in and trade with the countries of East and Southeast Asia. Asian countries, seeing not only

Europe 1992 but also the U.S.-Canada free trade agreement, should be dissuaded from contemplating a kind of "defensive alliance" in their region.

This heightens the importance of the current Uruguay Round of GATT negotiations. The 1988 Trade Bill instructed the U.S. to expand GATT agreements into new areas such as services and investment, and to improve GATT mechanisms for dealing with disputes and with national subsidies. Fundamentally, the "GATT system" is rules-oriented, with all nations asked to negotiate common understandings of "free trade," and then to compete fairly on the basis of these accepted rules. Under a "rules-oriented" trade system, specific outcomes in terms of trade and investment flows are produced by the workings of the system, and are not negotiated or known by the players beforehand. Most of the challenges to the GATT in the past decade have arisen when major players became dissatisfied with the trade outcomes, and sought individual national strategies for improving their own outcomes.

If the world were to shift toward a more explicitly "outcomes-oriented" trade regime, the results could be far less favorable. At the Joint Economic Committee's hearing on Japan, witnesses cited the recent U.S.-Japan semiconductor agreement as an example of misguided outcomes-oriented negotiations. Instead of expanding opportunities for U.S. producers to export to the Japanese market, the agreement merely provided for an expanded market share for "foreign-owned semiconductor manufacturers." The Japanese were willing to let foreign firms set up shop in Japan using Japanese labor. This does not benefit U.S. workers, or indeed the workers in the semiconductor industry elsewhere in the world. Much the same can be said of the U.S.-Japan "voluntary restraint agreement" on automobiles. The U.S. negotiated a given number of <u>units</u> rather than a given <u>dollar value</u> of Japanese imports. This encouraged Japanese auto producers to export more high-value cars to the U.S. market, increasing their market share in this important area while meeting the quantitative targets negotiated in the VRA.

Avoiding these kinds of outcomes, which are divisive and economically inefficient, is just one more reason why the United States should cut its budget deficit, reduce its savings shortfall, and make the investments necessary to increase its productivity and technological advancement.

CHAPTER IV. THE BUDGET

INTRODUCTION

As Chapter II has indicated, the Federal budget deficit drains our National saving, and weakens the foundation for our living standards in the future. Even though there is controversy over a wide range of choices in economic policy, there is virtual unanimity that the deficit is too large. Yet this consensus has not led to any meaningful deficit reduction agreement.

It is no surprise that the Nation cannot agree on a deficit reduction strategy. A group of informed citizens might quickly agree that Federal spending should be cut by one-eighth, the fraction needed to eliminate the deficit; but it is unlikely that they would agree on how to do it. One individual who travels frequently might want to protect highway and airport construction. Another who has lost a friend to an illness might boost spending on the National Institutes of Health. Another with an elderly parent might countenance no reduction in Social Security or Medicare. Someone else might want increased foreign aid. And no one longs to pay more taxes.

There is also considerable ignorance about the deficit. There are frequent broad statements that "there is plenty of fat in the budget," but few observers are willing or able to specify exactly where they could wring it out. There are equally frequent allegations that increases in taxes have automatically fed still greater increases in spending, forgetting that the deficit has been reduced modestly over the past four fiscal years because tax revenues grew without commensurate increases in spending. There are assurances that revenue growth over the next few years will be more than enough to eliminate the deficit, but without reference to the growing Federal obligations in widely accepted programs such as Social Security.

This chapter examines the history, the present status, and prospects for the budget in some detail. It identifies the roles of individual programs in the growth of the budget over the last two decades. It analyzes the budget today to show how much of total spending is accounted for by specific programs. And finally, it examines the budget outlook, to determine whether we can "grow out of" our deficit problem through spending restraint and the built-in upward drift of tax revenues.

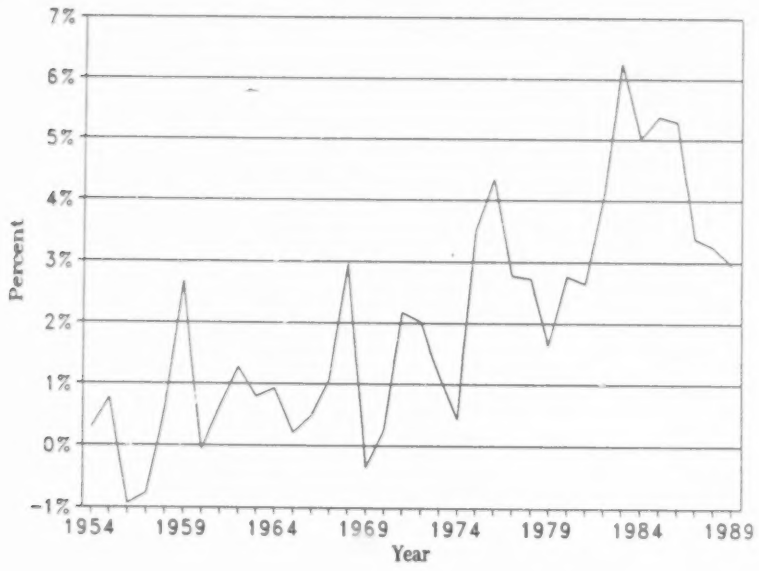
In sum, this analysis shows that the growth of the deficit was caused not by runaway spending across the board, but by a small set of discrete policy decisions, including a greater commitment to National defense and support of our elderly, and especially a large reduction in taxes. Many programs vital to the long-run economic health of the Nation have been progressively squeezed to make room for the large tax cut; and spending other than on these high-priority programs, and on other programs with broad popular support, is too small to yield the savings needed to balance the budget. Finally, the growth of revenues under a prudent economic forecast will not provide sufficient deficit reduction over the foreseeable future. So there are no painless answers to our deficit problem, and a successful attack upon it can be mounted only with honesty and cooperation from all sides.

THE FEDERAL BUDGET, 1954 TO 1989

The Long-Term Trends

In the 1950s and the 1960s, budget deficits were low relative to the size of our economy (or in technical terms, as a percentage of our GNP). Now, the deficit is significantly higher – in fact (as was pointed out in Chapter II), still at a level that was typical of recessions in earlier decades, even though the economy is seven years out of the last downturn (see Figure IV.1). (This perspective holds true even if state and local government surpluses are added to the Federal deficit.)

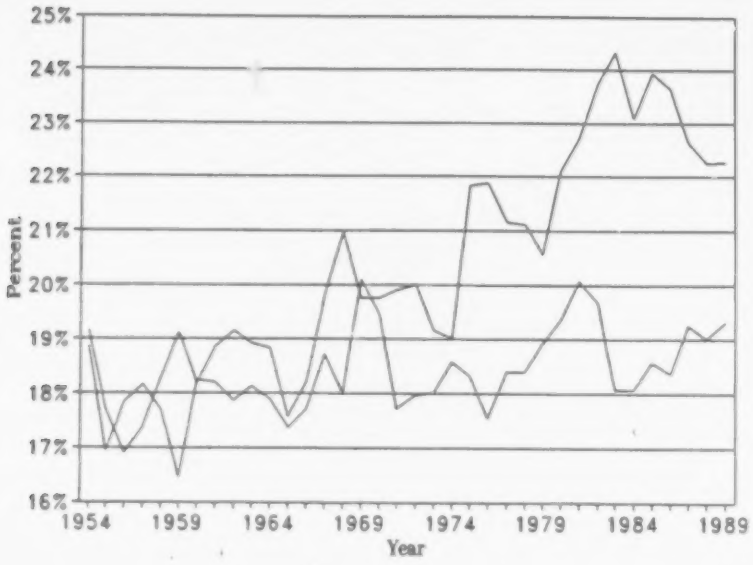
Figure IV.1
Deficit as Percent of GNP,
Fiscal Years, 1954-89



Source: Budget of the United States Government.

Figure IV.2 indicates that total spending increased consistently as a percentage of GNP over the post-World War II period, while total taxes held relatively steady. However, Federal spending is comprised of many different programs; and Federal revenues are the sum of several different taxes. Hence, looking only at the totals of revenues and expenditures does not explain what drove those totals, and hence why the deficit increased as it did.

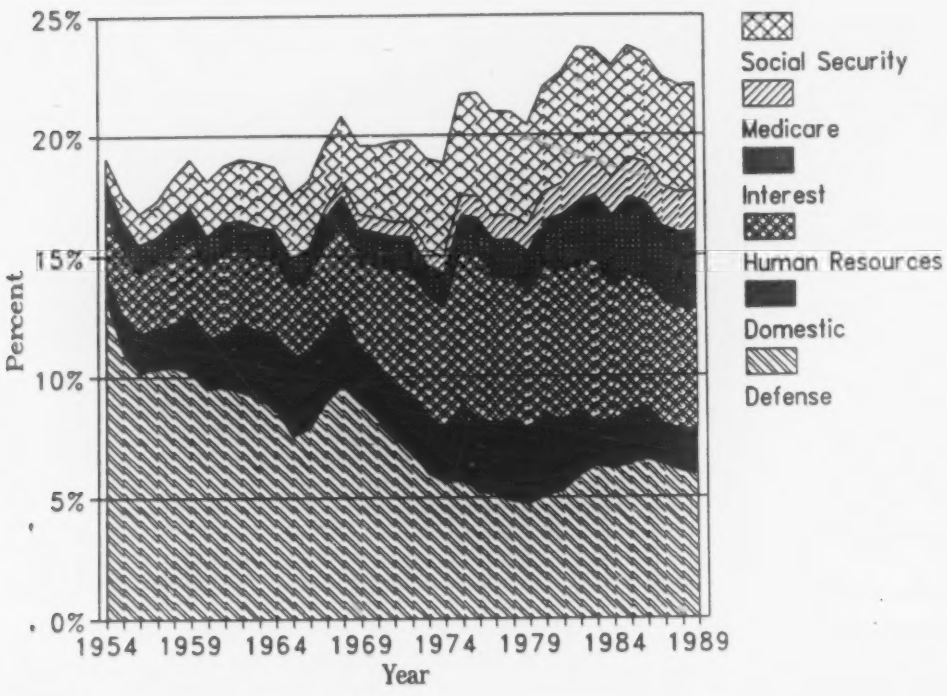
Figure IV.2
Outlays and Revenues as Percents of GNP, Fiscal Years 1954-89



Source: Budget of the United States Government.

The budget data analyzed by program show a distinct pattern. The growth of spending, and a growing share of total taxes, have come from Social Security and Medicare. (Note that the Balanced Budget Amendments of 1987 removed the Social Security retirement, survivors, and disability trust funds from the budget, and Medicare's hospital insurance trust fund is also scheduled to be taken out of the budget starting in 1993.) Figure IV.3 shows that spending on Social Security has grown from 0.9 percent of GNP in FY54 to 4.4 percent in FY89, while spending on Medicare, which began operation in FY66, has grown to 1.7 percent of GNP by FY89. Absent these programs, spending has had no upward trend relative to GNP over the entire period.

Figure IV.3
Outlays by Program Category as Percents of GNP, Fiscal Years 1954-89

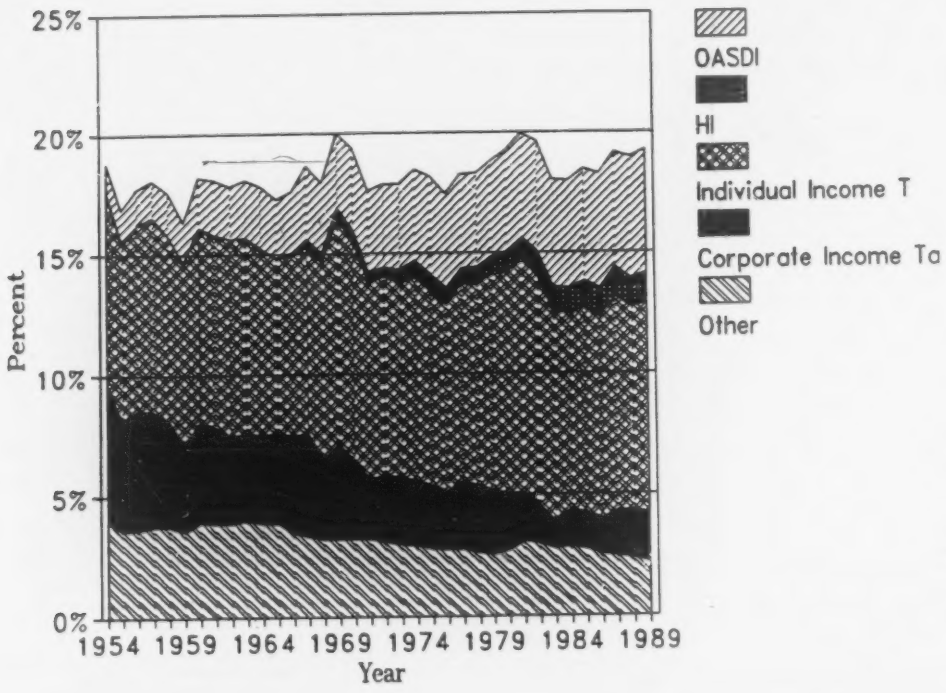


Source: Budget of the United States Government.

One more useful perspective on the budget is spending net of Social Security, Medicare, and net interest. The Government's debt service is not a discretionary expenditure, and it is not determined, except in the most indirect sense, by any individual spending decisions -- only by the excess of total spending over total revenues. And as Figure IV.3 shows, if we consider spending other than Social Security, Medicare, and net interest -- in other words, program spending other than Social Security and Medicare -- there has been a distinct downward trend over virtually the entire post-Korean War period: from 17.0 percent of GNP in FY54 to 12.9 percent in FY89.

Similarly, excluding Social Security taxes, which go directly to the trust funds and are therefore now off budget as well, changes our perspective on revenue trends. Figure IV.4 shows that while total revenues have been relatively flat as a share of GNP, revenues exclusive of the payroll tax for the Social Security retirement, survivors', and disability have declined steadily --from 17.6 percent of GNP in FY54 to 14.2 percent in FY89. Factoring out the payroll tax for Medicare (which funds only part of the program) makes the decline even steeper.

Figure IV.4
Revenues by Source as Percents of GNP,
Fiscal Years 1954-89



Source: **Budget of the United States Government.**

Figures IV.3 and IV.4 demonstrate that it is simplistic, and not useful, to assign the growth of the deficit to a victory of rising spending over constant taxes, as might be suggested by the aggregate view in Figure IV.2. Both the Congress and the recent Administrations have viewed the Social Security system as a self-contained unit, with taxes that offset benefit outlays; and have made changes only with caution given the long-term commitment to present and future beneficiaries. Setting those categories of spending aside, the others have not grown relative to the size of our economy. And excluding the Government's net interest obligations to look only at the programs that fundamentally determine outlays shows that spending has actually declined substantially as a share of GNP; but taxes other than Social Security have declined even more.

A Focus On The 1980s

A narrower question is the source of the budget deficit explosion of the 1980s. While the deficit in the 1970s was somewhat above its longer-run level, that departure was largely caused by the cyclical instability of the decade, including the effects of the two oil shocks. In contrast, the large deficits of the 1980s have persisted beyond the end of the 1981-82 recession, and while commodity prices have been falling or stable. The issue is not so much the recession-associated deficit growth of the early 1980s, but rather the staying power of the deficit through the end of the decade.

The data make clear that the deficit growth was not caused by domestic discretionary spending. In fact, this category declined from 5.6 percent of GNP in FY79 to 3.8 percent in FY89, while the deficit increased from 1.6 percent to 3.0 percent. Domestic discretionary spending includes many vital National investment priorities, including infrastructure, environmental protection, law enforcement, and research and development; these programs have suffered over the decade. Entitlement spending grew from 9.6 percent of GNP to 10.8 percent over the same period, but that growth was dominated by Social Security and Medicare (which together more than account for the increase). The change in Social Security, in particular, was endorsed by a broad political consensus, and is financed by payroll taxes earmarked for the trust fund to secure our social contract with current and future retirees.

Defense accounts for a large share of the increase in spending; this category grew from 4.8 percent of GNP in FY79 to 5.9 percent in FY89, and was even higher in mid-decade (6.5 percent in FY86). It is a judgment call whether that spending growth trend was good policy, but the contribution of defense to the deficit is a mathematical fact.

Over the course of the decade, however, the fastest growing category of spending is net interest – which grew from 1.7 percent of GNP in FY79 to 3.3 percent in FY89. The 1.6 percentage point increase in net interest, as noted in Chapter II reflects all the forces at work on both sides of the ledger that contributed to surging debt. This includes the depth of the 1982 recession, but also the mid-decade peak in defense spending and the valley in receipts. In fact, the growth of net interest puts the overall responsibility for the deficit in an entirely different light. Between FY79 and FY89, non-interest spending – including Social Security and Medicare – increased by only 0.2 percent of GNP (from 18.8 percent to 19.0 percent).

The Federal Budget Today

Looking at today's budget from this same perspective shows that eliminating the deficit will be far more painful – and will require far more hard choices – than some observers might suspect.

At the midsummer review of the budget for FY90, total spending projected by the Congressional Budget Office (CBO) was $1.212 trillion under the laws then in existence. Subsequent congressional action made some changes, of course, but given the temporary nature of many of the actions, they do not change the fundamental picture much. The associated CBO projection of the deficit was just 12 percent of total spending – suggesting that cutting to balance would be easy. However, spending is highly concentrated in a few large programs, and those and many other programs are difficult or impossible to cut. For example, as was mentioned above, Social Security and

Medicare are politically sensitive, and Medicare costs have been rising rapidly because of the growing number of elderly, the increasing average age within the elderly population (which increases their need for care), and the rapid inflation in medical care costs generally. Net interest is a legal obligation, and cannot be cut. Further, the Nation has ignored important priorities and faces enormous contingencies – the environment, transportation and other infrastructure, AIDS, the war on drugs, the savings and loan crisis – that leave much of the budget in need of increase rather than ripe for cutting.

Table IV.1 divides total spending into five categories, to show how little of the total realistically can be attacked to reduce the deficit. The first category includes programs that address the Nation's widely recognized priorities and contingencies: science, space, and technology (including research for productivity enhancement, and the President's priority for manned space flight); pollution control and abatement; transportation; elementary, secondary, vocational, and higher education (targeted by the President and by many outside observers as essential for economic competitiveness); health research, education and training; consumer and occupational health and safety; and the administration of justice (which includes law enforcement). It is optimistic to assume that our priorities in these areas could be addressed at current spending levels, with only increased efficiency to fund greater effort. For purposes of exposition, let us make that optimistic assumption. In President Reagan's detailed FY90 request, these programs consume about 9 percent of total spending (down from over 10 percent in FY79).

The second category is programs that have strong political support, including Social Security, Medicare (which has defied repeated efforts at cost cutting without service reduction), veterans affairs, and agriculture (which is already assumed to decline substantially in the long run). These programs consume about 34 percent of total spending, up slightly from about 32 percent at the start of the decade.

The third category of spending contains two programs that have a compelling legal or political rationale. Net interest is a legal obligation, and the Federal retirement programs have just been reformed and are unlikely to be trimmed further. Largely because of the growth of the net interest function, these programs are up to 16 percent of the budget, from about 10 percent in FY79.

The fourth category of spending includes the defense and international affairs programs. Over the short term, the defense budget is dominated by personnel costs and contractual procurement obligations. Personnel costs may be gradually reduced, but cannot be cut substantially in the short run; and it is uneconomical to slash or stretch out procurement without a clear sense of new mssions and directions. Our international affairs commitments are strained by the Third-World debt contingency and the need for security for our personnel abroad. These functions absorb about 28 percent of the budget, up from about 25 percent in FY79.

Table IV.1
Federal Government Spending by Program Categories, Selected Years

	1979 Amount (Billions of Current Dollars)	Percent of Total Spending	1990 Amount (Billions of Current Dollars)	Percent of Total Spending
Priority	52.7	10.5	101.1	8.8
Veterans; Social Security; and Agriculture	161.7	32.1	387.4	33.6
Net Interest; Federal Retirement	51.1	10.1	186.5	16.2
Defense; International Affairs	123.8	24.6	320.3	27.8
Total	389.3	77.3	995.2	86.4
Other	114.1	22.7	156.6	13.6
Addendum:				
	Amount (Billions of Current Dollars)	Percent of "Other" Spending	Amount (Billions of Current Dollars)	Percent of "Other" Spending
Deficit	40.2	35.2	128.0	81.7

Note: Priority programs include: General Science, Space, & Technology; Pollution Control & Abatement; Transportation; Secondary, Vocational, and Higher Education; Health Research, Education, Training, and Consumer and Occupation Health and Safety; and Administration of Justice.

Source: *Budget of the United States Government*; Congressional Budget Office. Items may not add to totals due to rounding.

Thus, over 86 percent of the budget for FY90 is absorbed by spending categories that will be unwise, or difficult if not impossible to cut. The remainder of the budget amounts to less than $160 billion. The deficit for FY90 is now estimated by CBO at about $128 billion; and while economic conditions and legislative action have changed the budget outlook, it seems most unlikely that $128 billion of fat could be found in $160 billion of programs. In fact, of this residual category of programs, more than 80 percent is income support, training, and medical services for individuals; these programs are all based on need. Only about 5 percent is general government activities.

BUDGET PROCEDURES AND THE DEFICIT

The Nation's fiscal problems were not caused by details in our budget process. In the words of Herbert Stein, testifying before the Joint Economic Committee this year, "In each case the officials were advised by the people who should have been advising them. In each case the decisionmakers had access to all the known information. The decisions were not made hastily. They were made with deliberation and they were made repeatedly. They were not accidents." We were not trapped by the process; we simply made the wrong choices.

However, there is one flaw in our current budget process whose correction would contribute to a solution to the deficit problem. The Balanced Budget and Emergency Deficit Control Reaffirmation Act of 1987 gave to the Administration the ultimate authority to specify the economic assumptions upon which we plan our budget. The economic assumptions set the course for the entire budget process to follow. If the process is based on assumptions of an unrealistically favorable economic performance, it will not motivate a serious deficit reduction effort.

Someone aptly applied the phrase "smoke and mirrors" to the process of budgeting in this era of large deficits. The phrase suggests creating the appearance of addressing the problem now, while in fact putting it off until later. Using this metaphor, the "smoke" is the Administration's optimistic economic assumptions. If we assume that real economic growth will proceed robustly into the future, we can show that Federal revenues will grow more rapidly, and that Federal income support program costs will grow more slowly. And if we assume at the same time that interest rates will decline, we can show that the costs of servicing the National debt will be less. So the "smoke" of optimistic assumptions on growth and interest rates can hide an unfavorable deficit outlook.

The sitting Administration has every incentive to claim, as they have in every recent year, that the economy will grow rapidly and that interest rates will fall. It demonstrates their confidence in their stewardship of the economy -- and it also reduces the amount of policy pain they must impose to meet the deficit reduction targets in their budget. For these reasons, the Administration has consistently underestimated the deficit in its forecasts over the decade.

So then, under the new deficit reduction law, the Administration passes its optimistic economic assumptions to the Congress. Of course, we in the Congress need not accept these optimistic assumptions for our own planning; we could use CBO's more realistic assumptions. And furthermore, it is in our interest to decry the optimism of the Administration's forecast. But it is also in our interest to accept that forecast, because it minimizes the degree of pain that we must impose. So in the recent past, we invariably accepted the Administration's scenario.

The "smoke" of optimistic economic assumptions set the stage for the "mirrors" of budget implementation. The mirrors are usually deceptive accounting techniques that reduce the deficit this year by $1.00 at the cost of increasing it in the future by that same $1.00, plus interest -- or even backdating an expenditure to a previous fiscal year whose deficit target has already ostensibly been met. A prime example of such manipulation is the recent practice of advancing or postponing of military paydays, to shift the costs from one fiscal year into another.

The revision of the deficit reduction law, giving the Administration sole control over the economic assumptions used in the budget, has facilitated the creation of a new and sophisticated division of labor between the Administration and the Congress: they provide the smoke, and we provide the mirrors. This development reduces the chances that the Administration and the Congress will address the deficit problem until a full-blown crisis imposes enormous economic costs.

This is even more the case because the Administration's optimism increases over the span of the deficit projection; note their assumption of a continued resurgence of economic growth accompanied by a decline of interest rates. Optimism in the short run means that the Congress can use its budgetary mirrors to meet the deficit targets; more realistic assumptions would put the deficit beyond the reach of the accounting gimmicks, and would require real policy changes. Optimistic long-run assumptions complete the loop, however, by making the postponement of the problem appear less irresponsible. If continuing rapid economic growth and declining interest rates year after year will make the deficit disappear eventually even without serious policy action, then short-term accounting manipulation seems acceptable.

This loop of smoke-and-mirrors compliance with Gramm-Rudman in the short run, and postponement and compounding of the problem in the long run, has contributed to the stretching out of the deficit problem over the decade of the 1980s. If these same techniques persist, they will extend and compound the risks that we run. Any recession, caused by an external economic shock or a loss of confidence on the part of our foreign creditors, would find us ill-prepared -- with the deficit rising too high to allow discretionary fiscal stimulus to cushion the recession, and soaking up capital needed to finance productive investment. And even without such an economic shock, the continuing drain on our National savings will erode our economic strength and living standards, through the next decade and into the next century.

To break this policy loop, we need prudent economic assumptions. Prudent assumptions would demonstrate that the deficit targets are out of the reach of accounting gimmicks, and would force all parties to address the deficit with real policy changes. The first step in any deficit reduction program is getting prudent economic assumptions from a political system that rewards and encourages a fanciful outlook.

A possible solution is to readjust the process and incentives determining economic assumptions. A bipartisan commission -- with two members appointed by the leadership of the Congress, two members appointed by the President, and the Chairman of the Federal Reserve Board as an ex-officio member -- could choose between the economic and technical assumptions put forward by the Office of Management and Budget (OMB) and CBO, without altering either. Because the commission would not create its own budget assumptions, but merely choose between assumptions formulated by preexisting agencies, it could be kept small and have limited staff.

Under such a system, the Administration would have a "reality check" on its economic forecasting. It would have to accept the judgment of a panel of economic and budgeting experts, and if its outlook was seen as too rosy, it would be dealt out of the game. It would most likely make economic projections that were far closer to the middle of the road than it has in recent years. CBO could be expected to continue its recent practice of moderate assumptions. The result would be a government-wide

economic forecast that would allow the President and the Congress far less latitude for game-playing and gimmickry on the budget.

This would not by itself require that those tough decisions would be made, or if they were, that the choices would be the best. In fact, virtually every American would be unhappy with some change in a realistic deficit reduction package, simply because the necessary steps would be so far reaching as to touch almost everyone. But deficit reduction is in the broad public interest, because the economic costs and risks of our continuing large deficits are excessive. Because economic assumptions start the budget process, sound economic assumptions are the best start for deficit reduction.

THE BUDGET IN THE 1990s

The Balanced Budget and Emergency Deficit Control Act of 1985, as amended by the Balanced Budget and Emergency Deficit Control Reaffirmation Act of 1987, requires that the unified Federal budget achieve balance in FY93. Attaining this target, much like attaining a hypothetical budget balance this year, will require more rigorous action than many observers would admit.

There are always differences of opinion over the projected budget deficit, but the further into the future the projection extends, the greater the range of uncertainty. That is because the performance of the economy can change more significantly from its current pace over greater spans of time, and even a small difference in the rate of change of output, for example, can compound itself into a large difference in GNP over several years. The Administration has projected that the budget will move into surplus by FY93 with limited, and largely unspecified, changes in policy. However, these projections follow the pattern of "smoke and mirrors" budgeting that has been established over this decade, in two major respects:

First, the Administration projects that real economic growth, after a brief slowdown to 2.5 percent per year, will rebound up to about 3.5 percent. While the economy grew at about a 3.5 percent pace during the recovery from the recession, the growth bonus that we enjoyed at that time from merely putting the unemployed back to work is now exhausted. Given that the labor force will grow by only about 1.0 percent per year (a rate largely already determined by the population of children already born), realization of the Administration's projection requires that output per worker grow by about 2.5 percent per year -- far greater than the 1.5 percent that the economy has averaged over the last four years. (Productivity grew faster in 1983 and 1984, but that was typical of the early bounce back from a recession; as an economic recovery matures into an expansion, productivity growth typically slows.) The Federal Reserve has made clear that it expects long-term GNP growth to average about 2.5 percent per year, which is the economy's current pace. The Federal Reserve would probably be pleased to be convinced by experience that growth was picking up. But until they are so convinced, the Federal Reserve's control over the money supply makes arguing with them over the potential rate of growth rather like arguing over the time left in the game with the referee holding the stopwatch.

Second, the Administration assumes, even as economic growth accelerates, that inflation and interest rates will fall. Inflation is projected to fall from the current pace of about 4.5 percent per year to about 3.0 percent by 1994. Interest rates of all maturities are projected to fall by more than 3 percentage points over the same period. At present, inflation is barely stable, and is certainly not declining, at growth rates of only 2.5 percent per year; and given current inflation rates and persistent budget deficits, interest rates are likely to remain high. The deficit has become highly sensitive to interest rates because debt service costs have grown to such a large share (about 15 percent) of the budget.

In contrast, CBO has produced an economic forecast that is closer to an extension of recent rates of growth of income and prices, and of recent levels of interest rates. It also follows more closely the economic outlook that is anticipated by the Board of Governors of the Federal Reserve, whose control over monetary policy helps to determine the rate of economic growth in the short run. This outlook provides a more prudent basis upon which to plan the Nation's fiscal policy. With this projected economic performance, the Federal budget deficit for FY93 will be reduced by no more than $10 billion compared to FY90 even after implementation of the Bipartisan Budget Agreement.

If the Nation does begin the next budget process with realistic economic assumptions, the deficit gap that we face -- in either the immediate term or the long run -- will be enormous. And just as it is tempting to assume that the problem will vanish in the face of a favorable economic performance, so is it tantalizing to count on the reduction of international tensions, or cuts in domestic programs. However, neither of these sources is likely to provide a painless fix.

The most optimistic current views might suggest that the entire deficit problem will be solved by reductions in defense spending. The dramatic lowering of the Iron Curtain, and the associated distraction and weakening of the Soviet threat, does offer real budgetary relief. Realistically, however, even if the Cold War is over, the deficit war is only begun.

When considering the defense budget, people often focus on conspicuous weapons systems; but such programs comprise only a small part of overall defense spending in any given year. Total procurement accounts for less than 30 percent of defense outlays; and strategic forces (excluding research and development on new systems) account for less than 10 percent of the defense budget. Saving even modest sums in the weapons area would be difficult because much of procurement is under long-term contracts, take years to complete, and would be expensive to terminate. Furthermore, postponing or stretching out procurement of needed weapons systems to save money in the short run usually increases costs in the long run. Substantial savings -- say, $10 billion to $20 billion per year -- would require concellations of numerous current programs.

The bulk of defense spending goes for general purpose forces and related functions, including training and readiness, supply and maintenance, intelligence, guard and reserve activities, administration, and airlift and sealift. Reduced tensions with the Soviet Union, and a lesser need for a rapid mobilization capability in Europe, may allow savings in these functions. But it is unlikely that these reductions will be large enough in the near or medium term to solve the deficit problem.

Releasing troops on short notice would involve substantial hardship, and thus would require offsetting expenditures -- not least among them in the pension area. Closing the bases and production facilities that house and outfit those troops would impose economic losses on particular communiites. Presumably, those effects will cause us to move cautiously, and to apply some of the savings to ease the transition.

The size and composition of defense reductions will also be constrained by the residual military threats to our security and other factors that require the maintenance of a large defense program. The Soviet Union will remain a military superpower and will maintain a nuclear capability, which we must deter; and its reforms thus far, however dramatic, could be reversed suddenly. Thus, we will need continued lift capability, and a smaller active duty force may require a larger reserve. Many other nations have substantial military capabilities. The United States has a number of defense responsibilities around the world, including recently defined tasks for the war on drugs which could be enlarged. Most people would agree that it is important that we stay up to date on military technology and that research and development activities not be drastically reduced.

Finally, the likely scale of potential defense reductions should be kept in perspective. The burst of weapons procurement in the early and mid-1980s set in motion high levels of production and deliveries of hardware, and corresponding increases in manning, training, and maintenance costs. This "bow wave" of increased costs will swamp even the Administration's FY90 budget proposals for increased defense spending, and goes far beyond the baseline of zero real growth established by the Congress. Substantial cuts will be necessary just to meet the current CBO projections.

Setting these concerns aside, one can speculate about the effects on the budget of varying levels of defense cutbacks. Suppose the defense program was reduced from the current baseline by one-third over the next 10 years. By coincidence, assuming 4.5 percent annual inflation (very close to CBO's assumptions), this could be accomplished by holding defense spending constant in nominal dollars over the 10-year period. (Higher or lower inflation would require different nominal spending to achieve the same inflation-adjusted defense effort, of course.) If defense spending stayed at the FY90 level of $301 billion, that would yield savings of $38 billion in FY93 (relative to CBO's baseline of $339 billion for that year). While these savings would be most welcome, they would be only a part of the solution to our FY93 deficit problem, now estimated by CBO at $126 billion.

Nor is there an obvious solution on the domestic side of the budget. In his farewell budget submission for FY90, President Reagan offered a long list of domestic spending cuts that had been rejected before, and were rejected yet again, because they violated many people's conceptions of the appropriate role of the Federal Government. (Included were elimination of Federal subsidies for Amtrak, mass transit, community development projects, and Small Business Administration disaster assistance loans; cutbacks in sewage treatment grants, and Rural Electrification Administration and Farmer's Home Administration loans; and reductions in Medicare, Medicaid, Federal employee retirement COLA's, reduced-price school lunches, and other entitlements.) Those cuts met the FY93 goal of a balanced budget, but only because they built upon overly optimistic economic assumptions.

Assume that all of those spending cuts were accepted. According to CBO, they would provide savings of only $46 billion relative to a continuation of the current level of those programs -- again, only a part of the FY93 deficit reduction task.

And even after such spending cuts in both defense and domestic programs, the Nation would need to address its recently ignored priorities and contingencies. New construction of airport facilities is overdue, as is maintenance of roads and bridges. The AIDS crisis, the deterioration of the ozone layer, and nuclear and other toxic waste cleanups could impose significant costs, and we should be prepared. Many authorities advocate much larger Federal investments in education, child care, health, and research and development. We should have a fiscal cushion to respond to disasters at home (like Hurricane Hugo and the San Francisco earthquake) and to diplomatic opportunities abroad (like the fall of the Iron Curtain and the development needs of the newly open East Bloc nations). And finally, the Social Security surplus, meant to accumulate as greater National savings to fund the retirement of the Baby Boom, is now being spent, implicitly, on current programs. Making that accumulation meaningful would require still further deficit reduction.

CONCLUSION

Eliminating the deficit with only spending restraint is unrealistic, even with the most optimistic defense reductions and the most optimistic domestic spending cuts. To get close to budget balance by FY93, we would have to think on a scale even beyond that of the Reagan FY90 budget and blue-sky savings on defense.

That means that a tax increase will be essential. But deficit reduction with only tax increases is politically impossible. The only way out of the box is a package deal that includes spending restraint in a broad range of programs, plus a modest tax increase. The best package would spread the pain as thinly as possible, so that no one was overly burdened, but everyone contributed; and would impose the least distortion and disincentive upon the economy. Deficit reduction can be achieved without income tax rate increases.

Different citizens have different values, and different needs for government services -- be they highways, airports, National security, or support for the elderly. No one politician or economist can promulgate the single answer to deficit reduction. The size of the problem requires that we review a long list of potential deficit reductions, on both the spending and the tax sides of the ledger, to assess how they meet the Nation's needs. And these needs also require that we make room for necessary initiatives to address neglected National priorities. It will be a painful process, but if we are to end the deficit's drain on our Nation's savings, we must begin.

CHAPTER V. MICROECONOMIC POLICY ACTIONS OF 1989

This chapter provides brief analyses of selected economic policy actions taken or debated in 1989 that would affect particular groups or sectors of the economy. Economists would call these microeconomic policy actions, because they have a limited focus, rather than bearing on the economy as a whole.

While a number of policy steps were contemplated in the first session of the 101st Congress, most will be carried over to the new session next year, keeping micro-economic policy near the top of the Congressional agenda.

CATASTROPHIC HEALTH CARE COVERAGE

The Medicare Catastrophic Coverage Act (MCCA) of 1988 was passed by large bipartisan majorities in response to a long-standing concern that many elderly were inadequately protected against catastrophic medical expenditures. Only one year later, intense criticism of the program led to repeal of MCCA by equally large bipartisan votes. These decisions have profound implications for health care policy with respect to both expenditures and access to care.

Background

Many Medicare beneficiaries are not protected against catastrophic medical costs -- either from acute care expenditures on intensive hospital care or from expenditures on chronic long-term care. Catastrophic medical costs are broadly defined as out-of-pocket health care expenditures that are large in relation to a fixed dollar amount (in excess of $1,000, for example), or relative to income (in excess of, for example, 2 percent of income). The Department of Health and Human Services estimates that between 4 percent and 8 percent of the elderly population (compared with 1 percent to 3 percent for the non-elderly) incurred catastrophic health care expenses in 1986.

Based on 1984 expenditure patterns, per capita health care expenditures for the elderly now exceed $5,000 -- three times those of the non-elderly. Of this amount, about one-quarter or $1250 represents out-of-pocket expenditures. Prior to the enactment of the MCCA, Medicare covered only about one-half of the health care expenses of the aged. Deductibles and coinsurance payments for covered services, and charges for services not covered by Medicare (such as outpatient prescription drugs and nursing home care), are financed out-of-pocket unless covered by other medical insurance.

More than 60 percent of Medicare beneficiaries had additional private health insurance purchased individually (so-called Medigap policies) or obtained through current or former employment; an additional 10 percent of beneficiaries are also eligible for Medicaid. But the remaining one-quarter of Medicare beneficiaries have no additional insurance, and even those with private supplemental health insurance could incur catastrophic health expenses. Prescription drugs are usually not covered, and there are often limitations on the number of covered in-patient hospital days. And, of course, few people have private insurance to cover nursing home costs, a benefit

covered by Medicare only for temporary stays following hospitalization associated with an acute illness, not for long-term care.

Provisions of MCCA

To fill some of these gaps in coverage, the MCCA provided (1) payment for unlimited in-patient hospital days with only one annual deductible (beginning at $560 in 1989); (2) a cap (beginning at $1360 in 1990) on patient responsibility for deductibles and co-insurance charges for physician, outpatient, and other services covered under Medicare Part B; and (3) coverage for out-patient prescription drugs above a deductible (beginning at $600 in 1991) with coinsurance payments decreasing to 20 percent by 1993. When fully implemented, the MCCA would pay for additional health care expenditures for approximately 22 percent of Medicare enrollees.

The five-year (1989-1993) cost of the program was initially estimated at $31 billion. Revised estimates put the cost at $48 billion, with the annual cost rising to $15 billion by the end of the five-year period. Approximately one-third of the cost was financed by an increase in the monthly Part B premium – $4 in 1989, rising to $10.20 by 1993 as more benefits would be phased in. The remaining two-thirds of the cost was to be financed by an income-related supplemental premium equal to 15 percent of the excess of income tax liability over $150 (so that those owing less than $150 of income tax did not pay), with a maximum premium of $800 in 1989. By 1993, the supplemental premiums would have increased to 28 percent of tax liability with a maximum of $1050.

Criticism of MCCA

Only about 40 percent of Medicare enrollees would be subject to the supplemental premium, and less than 10 percent would pay the maximum annual premium of $1050 in 1993. Yet the most vocal and persistent criticism centered around this income-related premium. Critics argued that, on average, the 40 percent liable for the supplemental premium would pay almost twice as much for catastrophic insurance as they received in benefits; while the 10 percent paying the maximum supplemental premium would contribute three times their benefits.

Proponents of the legislation argued, however, that even a beneficiary making the maximum contribution for the Medicare program (including employee and employer payroll contributions connected with lifetime work history, interest on those contributions, and supplemental and monthly Part B premiums) pays only about two-thirds of the cost of the associated benefits. Thus, even the high-income elderly receive a subsidy equal to about one-third the cost of their lifetime Medicare benefits. Further, given Federal budget deficits, general revenues could not be used to finance an expansion of Medicare benefits. The supplemental premium was intended to make the program affordable to low-income Medicare beneficiaries, without fully offsetting the Medicare subsidy received by high-income elderly individuals.

A further issue was the more than 60 percent of Medicare enrollees who supplement their Medicare coverage with some form of private health insurance. Critics claimed that the MCCA duplicated much of this private coverage, and that some persons would incur higher premiums with no more protection. The other side of the coin was the almost one-quarter of Medicare enrollees who have no additional coverage. Also, some health services, such as prescription drugs, often are not covered by private

plans; and private plans were required by the MCCA to eliminate duplicate coverage, substitute other health benefits, and/or reduce premiums.

Finally, critics argued that the major gap in Medicare coverage was long-term care. Since few private insurers cover nursing home costs, Medicaid remains the primary insurer. The United States Commission on Comprehensive Care -- the Pepper Commission -- was established in recognition of the cost and complexity of a comprehensive long-term care program. A major part of its mandate is to make recommendations to assure the availability of comprehensive long-term care services for the elderly and disabled.

Congressional Action

Some critics of the MCCA favored its repeal so that it could be redesigned -- perhaps by the Pepper Commission. The House left this option open when it voted, 360 to 66, for repeal. The Senate, by a vote of 26 to 73, initially rejected repeal and attempted to save as much of the program as could be financed with the flat monthly premium (primarily unlimited coverage for in-patient hospital expenses). Ultimately, after several attempts to compromise and save part of the program, the Senate accepted the House position and all the Medicare provisions of the MCCA were repealed, effective in 1990.

Health insurance will remain on the national agenda. The legislative history of the MCCA only emphasizes the problems of our health care system. Rising costs, the AIDS epidemic, concerns over the quality of care, and the increasing number of Americans without health insurance convince more and more Americans that this country must provide basic health care for everyone. This cannot be achieved quickly. Some segments of the population will need a public-private partnership to reach this goal. For other segments of the population the public sector will need to assume the major role. The legislative history of catastrophic health insurance can teach us much about an appropriate public-private division of responsibility. Before deciding on the best strategy, we should study the recommendations of the Pepper Commission due this Spring.

MEDICARE PHYSICIAN PAYMENT REFORM

Medicare physician reimbursement was overhauled in the FY90 budget reconciliation bill. The centerpiece is a nationwide fee schedule (derived from a resource-based relative value scale, or RBRVS, to be phased in over five years beginning in January 1992) to replace the Medicare practice of paying "reasonable charges." The goal is to reduce overcompensation for surgery, diagnostic tests and other costly procedures, and undercompensation for more cost-effective "primary care" services like examining and counselling patients. Other provisions will monitor the volume of services and increase Public Health Service research on the effectiveness of medical treatments.

Background

Between FY80 and FY88, Medicare spending for physicians' services grew at 14.4 percent per year -- about half attributable to increases in the price per unit of service, and the rest to increases in the volume and intensity of services. Starting in 1984, the Congress approved amendments to physician payment rules to constrain these increases.

These measures have helped, but basic reforms in physician reimbursement were still needed. Specifically, the relative prices of services often bore little relation to the relative costs of providing them, and so some medical services generated more "profit" than others. These profits encouraged inappropriate treatment.

In 1986, the Congress required the Secretary of Health and Human Services (HHS), with the advice of the newly established Physician Payment Review Commission (PPRC), to develop a relative value scale. The 1989 Annual Report to Congress of the PPRC recommended a Medicare fee schedule based on a relative value scale, a national expenditure target to determine annual updates in the fee schedule, and other policies to slow the increase in expenditures. The FY90 Medicare physician payment reforms followed these recommendations.

Current Payment Rules

Under the current fee-for-service system, physicians are reimbursed for each service they perform; the more services, the greater the reimbursement. For a given service, Medicare sets a "reasonable" (or "allowed") charge, defined as the lesser of (1) the physician's actual charge; (2) the physician's customary charge; or (3) the prevailing charge in the locality. In general, Medicare pays 80 percent of the reasonable charge, while the patient (or a private insurance company providing "Medigap" coverage) pays the other 20 percent, plus any excess of the bill over the reasonable charge.

Summary of Payment Reforms

The new payment reforms include a resource-based relative value scale (to be phased in over five years beginning in 1992); Medicare Volume Performance Standards (MVPS) beginning in 1990, under which unwarranted increases in volume in one year would be offset with fee reductions in subsequent years; a limit of 15 percent on the excess that may be charged over the Medicare fee schedule (to be phased in by 1993); and establishment of a new research agency within the Public Health Service to evaluate the effectiveness of medical treatments and to set guidelines for reviewing the quality, effectiveness, and appropriateness of medical care.

Numerous witnesses before the JEC Subcommittee on Education and Health (during 1988 hearings entitled "The Future of Health Care in America") argued that merely aligning the fee schedule with the cost of providing services will not control the increase in the volume of services. However, the new payment reforms are a package designed to both reallocate and constrain the growth of physician payments.

The new fee schedule reallocates funds among specialties. The PPRC estimates that payments will increase by 20 percent for medical specialties and decrease by 11 percent for surgical specialties. This reallocation is desirable because the profit in highly paid specialties is an incentive to overuse them. The RBRVS should reduce the incentive to provide unnecessary care. Furthermore, the increase in medical fees and decrease in surgical fees will encourage the kind of primary care that many analysts believe will improve health in the long run.

But physicians in specialties with declining fees could try to maintain their incomes by increasing the volume of services they provide. The MVPS is designed to prevent this. If expenditures exceed a target based on expected utilization, population growth, and increases in costs, then the annual increase in fees will be lowered as an offset. Provincial governments in Canada have successfully used this approach. Limits on the excess over the Medicare fee schedule will encourage physicians to adhere to it, and so out-of-pocket expenditures of Medicare beneficiaries should decline. And when combined with the realignment of fees, the evaluation of the effectiveness of medical procedures could restrain health care expenditure growth and increase the quality of care.

CHILD CARE

The federal role in child care issues has been subject to considerable debate over the past several years. As more and more mothers have joined the labor force, the number of families needing day care services has risen. Dissatisfaction with existing services is widespread. Two major sources of concern are the ability of working parents to afford adequate child care, and the quality of the child care services being provided. Approximately 100 bills were introduced in the 101st Congress dealing with one or both of these problems.

Working parents without a spouse at home must rely on others to care for their children during some part of the day. While studies generally indicate that adequate quantities of child care are available in the private market, good-quality child care programs tend to be fairly expensive. The average family using child care spends between $2000 and $3000 per year, and working poor families with children typically spend about 20 percent of their budgets for child care. Parents who are unable to afford high quality care may be forced to leave their children inadequately supervised if they are to earn a living.

Many of the current child care initiatives focus on helping lower-income families with young children to purchase adequate care. Under current law, parents who work may use the dependent care tax credit to claim reimbursement for a portion of their child care expenses for children up to the age of 13. This credit is not refundable, however, so lower-income families whose reimbursable expenses exceed the taxes they owe do not receive the full benefit. This credit reduced total tax revenues by about $3 billion in 1988.

While many analysts advocate changing our current system of support for child care to provide more benefits for lower income families, there is considerable controversy over the best method. The Administration has advocated a tax credit for all families with incomes under a cutoff (proposed to start at about $11,000), whether or not they actually use child care services. Families would choose between this credit and a new, refundable version of the dependent care credit, which would give cash "refunds" to families if their allowable expenses exceeded their tax liabilities. The argument made in favor of this approach is that limiting subsidies to those who actually pay for day care discriminates against women who choose to stay at home with their children, and may actually encourage women to work outside the home. On the other hand, families that do not pay for child care presumably have more income left to pay for other needs, and so they are somewhat less needy than families with the same

income who must pay for day care. Because the credits involved would average only about $700 per year, it is unlikely that they would substantially increase the number of mothers choosing to stay home. And subsidies going to mothers who have already chosen to stay home (and who presumably already provide quality care for their children) would do little to improve the quality of care affordable by those mothers who must work, for whom quality of care is an important issue.

Other options for increasing the ability of low-income families to afford adequate child care include expansions in the Earned Income Tax Credit (EITC), direct child care subsidies (e.g. vouchers), and increases in subsidies to child care providers, allowing them to provide more reduced-price services to low-income families.

The EITC is a refundable tax credit that provides benefits to low-income earners with children. In 1988 the EITC provided a maximum benefit of $874 to families with earnings of about $10,000, and phased out completely at about $18,500 in income. Currently, neither the number or the ages of the children in the family is taken into account in computing the EITC. One way to subsidize child care for low-income working families would be to raise the EITC and perhaps adjust it to account for the higher costs of having more or very young children.

Expansions of either the EITC or the Dependent Care tax credits, while they would address affordability issues, would do little to regulate or improve the general quality of day care. The federal role here is particularly controversial. While federal child care standards were first formulated in 1968, they have never been fully implemented even for child care programs receiving federal funding under Title XX of the Social Security Act, and in 1981 the requirement for any compliance was eliminated.

Opponents of federal regulation argue that there is too much variation across programs and among children for regulation to be useful, and that it would simply lead to higher costs with little or no improvement in quality. It is also argued that parents know what is best for their children, and that they should be free to choose to send them to whatever type of facility they want, even if it does not meet federal standards. Although all states regulate at least some types of child care providers, those favoring federal regulations argue that states vary too much in the scope and enforcement of their regulations. Many child welfare organizations advocate more extensive health, safety, and staffing standards that would apply to all child care providers other than relatives.

Child care legislation passed both the House and the Senate this year, although no final bill was enacted. In June the Senate passed the Act for Better Child Care Services of 1989, known as the ABC bill. This bill authorized outlays of $1.75 billion in 1990, most of this for a federal-state matching grant program to provide child care services for children under age 13 whose families had incomes below the state median. Child care services could have been provided through contracts or grants to providers (or to intermediaries such as local governments), or through vouchers given directly to parents. Providers receiving support, either directly or through parents' vouchers, would have been required to meet state licensing requirements (unless they were relatives of the child in question). A National Advisory Committee would have been established to develop recommended child care standards, and states would have been required to develop and enforce their own child care standards.

In addition, the ABC bill made the dependent care tax credit refundable, established a supplemental EITC for families with very young children (age 3 or under), and allowed a tax credit against health insurance premiums for such families. Under the supplemental EITC, families with one eligible child would have gotten a credit of 7 percent of earnings, up to a maximum credit of $500. Families with two or more eligible children would have received a credit of 10 percent of earnings, up to $750. The credit would begin to phase out at about $10,000 in earnings, reaching zero at about $15,000. The total cost of these new tax credits was estimated to be about $200 million in 1991, rising to $2.8 billion in 1994.

Both the Education and Labor Committee and the Ways and Means Committee in the House of Representatives passed versions of the Early Childhood Education and Development Act, which were consolidated into an extensive set of child care provisions that were included in the House Reconciliation package. These provisions would have authorized $1.75 billion in spending on child care programs, but a dispute between the two committees as to the details of the allocation was not resolved in the House-passed version. Under both versions, a substantial fraction of the money would have gone to expand day care provided under Head Start, while much of the remainder would have been used either to set up new child care programs for low-income families or to expand funding of such programs under Title XX.

Finally, the Ways and Means version also contained a provision, retained in the House-passed version, to expand the EITC substantially, pegging it to family size. Under this proposal, the proportion of earnings credited and the maximum credit would both have increased with family size up to three children. An additional credit would have been established for families with children aged five or younger. These changes were to be phased in, with costs rising from about $400 million in 1991 to $4.7 billion in 1994.

No agreement on child care issues was reached before adjournment, although small increases in the authorization for the Head Start Program and for Title XX were passed under Reconciliation. The appropriation for Head Start was not increased up to the level authorized, however, and in any case funding for both of these programs will be below previously authorized levels in fiscal 1990 because of sequestration.

New child care legislation is almost certain to be introduced in the next Congress. This legislation is likely to include a new version of the ABC bill and some expansion in refundable tax credits for low-income families. Some existing programs, including Head Start (which has a track record of effectiveness), are also due for re-authorization next year. It is important that we recognize the risk to the development and even the safety of children if their parents must work but cannot obtain adequate child care.

THE MINIMUM WAGE

The federal minimum wage is set by Congress under the Fair Labor Standards Act, and has been fixed at $3.35 per hour since January 1, 1981. Over the past nine years its real value has eroded by almost one-third because of inflation. To equal the 1981 value of the minimum today, the rate would have to be raised to about $4.65 per hour.

Who benefits from minimum wage laws? According to a Congressional Budget Office (CBO) study, about 5.2 million people, or about 10 percent of all hourly wage workers, reported having been paid at or below the minimum wage in 1984. About 19 percent of minimum wage workers were in families with total incomes below the poverty line, and another 12 percent had total family incomes below 150 percent of the poverty line. But the vast majority of low-wage workers were in families that were not poor or near-poor. However, poverty rates were substantially higher for minimum wage earners than for hourly workers earning at least $4.35 per hour, and most poor workers also earn low wages.

That relatively few minimum wage earners are poor is largely explained by the fact that about 70 percent are in families with at least one other earner. About 70 percent of minimum wage workers work part time, and about one-third are teenagers. Only about 12 percent of minimum wage earners reported having worked full-time and year round in 1984. The poverty rate for these workers was about 13 percent.

Because the real value of the minimum wage has declined so that it is no longer enough to bring a full time, full year worker with even one dependent out of poverty, many have argued that it is now inadequate and should be raised. Additionally, very low potential wages may constitute a work disincentive for some who live in poverty but do not now work. On the other hand, some economists believe that increases in the minimum wage may lower the demand for low-wage workers, resulting in more joblessness or fewer hours of work for those employed.

Studies of this issue have found the employment of teenagers to be somewhat sensitive to minimum wage changes, although few employment impacts have been consistently found for adults. Around the time of the last increase, several studies estimated that a ten percent increase in the minimum wage would result in a reduction in employment of one to three percent for teenagers. Unemployment rates, particularly for teenagers, are somewhat lower today than they were in 1981, however, and many employers are already paying above-minimum wages even for relatively low-skilled entry-level jobs. As a result, the impacts of a change in the minimum could be even smaller today.

Concern about potential employment impacts for teenagers, coupled with the belief that employers should be allowed to pay inexperienced young people less while they were learning to do the job, has led to a number of proposals for a "sub-minimum" or "training" wage for new workers, set below the level of the minimum wage. Those who oppose a sub-minimum, however, argue that it might simply cause employers to substitute new workers for older workers who would otherwise have been employed, with no net increase in the total number of jobs.

Congress passed a bill in May that would have raised the minimum wage to $4.55 per hour in a series of three yearly steps, the final step occurring on Jan. 1, 1992. President Bush vetoed this bill in June, and the Congress was unable to override the veto. The Administration proposed an alternative minimum wage package, calling for an increase to $4.25 per hour over three years, with a six-month sub-minimum wage that could be paid to any new hire, regardless of experience. Negotiations on the minimum wage issue continued over the Summer, with both Houses of Congress reporting out new bills. The new Senate bill was essentially similar to the one vetoed

in June, but the new House bill raised the minimum to $4.25 per hour over two years and included a two-month sub-minimum provision for inexperienced workers.

A compromise with the Administration was reached in early November. The final version of the 1989 Amendments to the Fair Labor Standards Act raises the minimum wage to $4.25 per hour over two years, with the first increase, to $3.80, occurring on April 1, 1990, and the second occurring one year later. The amendments allow for up to two 90-day "training" periods per worker (only one period with a given employer), during which the worker can be paid at 85 percent of the minimum. Only workers with less than six months of experience are eligible for the sub-minimum wage.

THE ENVIRONMENT IN 1989

This year added several major environmental challenges to our already long list. The Valdez oil spill and lesser spills on the east coast, toxic waste washing up on our beaches, and the food safety effects of Alar on apples were major news items. In addition, longstanding concerns over global warming, air and water quality, and solid, toxic and nuclear waste continued.

Linkages between the economy and the environment are becoming increasingly clear. Decisions by industry to adopt particular production techniques may lead to harmful effects on others. In some cases, such as illegal dumping of wastes, these effects may be immediate. In other cases the harmful effects may be recognized only later and may be controversial, such as Alar.

Most environmental concerns have many dimensions. Our failure to develop a comprehensive approach to environmental issues has resulted in conflicting policies and limited success. While the Environmental Protection Agency has the lead responsibility, other departments such as Energy, Agriculture, and Commerce are also involved. The overlap of jurisdiction carries through to the Congress; authorizing legislation comes from several Committees, and not surprisingly there has been little coordination.

In part, the coordination problem stems from the complexity of environmental issues. For example, the rapidly growing problem of solid waste can affect air quality if incinerators are used for disposal, which in turn can affect energy use if the incinerators are also cogenerators of power or heat. The decision to use incineration instead of landfill can cause a different landfill problem, because much of the ash from incinerators is classed as a toxic waste. This requires more stringent control of the landfill site, because of the danger of groundwater contamination.

There is also no obvious "best" approach for dealing with environmental problems. Both regulatory and market-based approaches have been tried with limited success. Regulatory approaches including prohibitions on particular activities (such as the discharge of wastes into rivers and streams), requirements that best available pollution control technology be adopted, and pollution standards (such as for automobile emissions) have been the principal tools. Mandating technologies has proven to be cumbersome, because technologies continue to evolve and differing conditions can require different approaches. Similarly, national standards for emissions ignore the different effects of given amounts of pollution in different areas. Efforts to use market forces are receiving greater attention as these difficulties with regulatory approaches are

recognized. There is renewed interest in such methods as tradeable emissions rights, which set aggregate pollution levels but allow individual firms to determine how to meet the target. In addition, price incentives (such as taxes on emissions) induce producers and consumers to recognize the environmental effects of their actions.

Oil Spills

The Alaska oil spill shows the problems with current approaches to environmental protection. The 11 million gallon spill contaminated Prince William Sound with likely long-term consequences. Initial containment efforts were hampered by inadequate equipment and lack of organization. Government relied on the companies to provide the men and materials as part of the Alaska pipeline agreement, but failed to monitor the companies' preparations, and the companies failed to meet their requirements. Adverse weather conditions, for which no plans were formulated, exacerbated the damage.

An important question is who bears the cost of cleaning up a spill. Existing Federal legislation provides limited protection to those affected by spills. Low limitations on liability desired by the oil companies and shippers conflict with the principle that those causing the problem should bear the consequences. In addition, there is no well accepted method for valuing the loss of wildlife or contamination of virgin territory. The spill also brought into question how damage would be corrected where the company responsible for the problem could not be billed for the cost. Should the domestic oil industry be compelled to contribute to an insurance fund? Should consumers be taxed directly, or indirectly, to cover the costs? How should spills originating in international waters be dealt with? All of these issues are left unclear in existing legislation.

The Clean Air Act

Reauthorizing the Clean Air Act presents another set of environmental problems. Air quality in some parts of the country is clearly inadequate; at issue is the desirability of national standards for technologies and abatement levels in all places. While the Federal Government sets minimally acceptable standards, some states require lower levels of pollution within their borders. Differing standards impose costs on car producers and consumers because of more complex assembly procedures, and are a cumbersome way of dealing with differing pollution loads on local environments. Also, to the extent that pollutants from one area affect another, local limits on emissions can result in too much pollution. The clearest example is the use of tall smoke stacks to float emissions out of the immediate neighborhood. While these stacks may achieve local emission limits, and there is some dilution of pollution from tall stacks, they are the source of pollution in downwind areas. Much of the debate over acid rain abatement involves who will bear the cost of controlling emissions in the mid-west which adversely affect New England and Canada.

Legislation proposed by the President this Summer addresses some air quality problems, but not all. Most alarmingly, it would weaken existing law in some areas, particularly automobile emissions. The central feature was a much stronger role for market-based methods; tradeable emissions rights for auto manufacturers and industrial and utility sources are the core of the President's proposal.

Car manufacturers would be required to meet fleet average emissions standards at the time of production, and would receive credits for cars that exceeded standards. Credits could be either sold to other manufacturers or used as offsets for cars with high emissions. The proposal was criticized in the Congress for ignoring problems of post-sale emissions (because of the complexity of enforcing different emissions standards on different vehicles years after production), and for relaxing current emission requirements for some models. (Proposed Congressional legislation retains maximum tailpipe emissions car-by-car.)

The President also proposed tradeable emissions rights to control point-source emissions causing acid rain. Companies would choose between curtailing their pollutants or buying emissions rights depending on the relative cost. While there is much to be said for this flexibility, the adjustment burden would fall mainly on states in the Midwest that rely on high-sulfur coal. Without some assistance, these states would face a severe burden. The Congress seeks to preserve the basic benefits of market-based adjustments while spreading the cost more broadly and fairly, but there is no agreement to date.

These and other controversies left the legislation in limbo at the end of this session. However, given the progress already made, and the recognition that each day of delay imposes a greater burden on the environment, reauthorization remains likely. It should be possible to resolve outstanding problems and pass a new Clean Air Act early in 1990.

Global Warming

Concern over depletion of the ozone and global warming, which first received major attention in 1988, continued in 1989. The consequences of even a small increase in average temperatures could be severe. The international dimensions of global warming require a multilateral effort; destruction of tropical rain forests and industrialization of developing countries add to the problems created by the developed world. While the long-term effects of chemicals such as chlorofluorocarbons, the clearing of rain forests, and the burning of fossil fuels are not yet known with precision, it is prudent to take steps now to alleviate depletion of the ozone layer and reduce airborne emissions.

FINANCIAL PROBLEMS IN THE THRIFT INDUSTRY AND DEREGULATION

Causes

In 1989, the President and Congress addressed the thrift industry's accumulated losses exceeding $100 billion and adopted far-reaching legislation to stem future losses. As President Bush indicated in early December, the total cost of the thrift debacle is still being counted and may require further funds in the next year or two. The staggering size of the losses in the thrift industry derives from several factors:

- ***Maturity structure***. Traditionally, the industry has obtained money short term but lent it long term. This causes losses during periods of rising interest rates as the new cost of money comes to exceed the interest received from old loans. A certain number of thrifts still operating in 1989 trace their troubles back to the 1979-82 rise in interest rates.

- ***Weakening real estate markets.*** Many parts of the country, particularly in the Southwest, have experienced falling real estate prices during the 1980s. This has weakened many borrowers' ability to pay and caused market values of collateral to fall below loan amounts.

- ***Greater risk-taking.*** FSLIC insurance was provided not only to federally chartered thrifts, but also to state-chartered thrifts which were permitted to engage more in riskier activities. In addition, federal legislation in the early 1980s directly and indirectly contributed to greater risk taking by many thrifts. First, the laws directly authorized investments (e.g., direct investments, junk bonds) inherently riskier than collateralized mortgage loans. Second, the laws authorized a reduction in capital standards and rules, which permitted many thrifts to continue to operate after they had become insolvent in practical terms. With no real capital of their own at stake, such thrifts are prone to taking bigger risks.

- ***Rapid growth.*** Raising the maximum deposit insurance per account from $40,000 to $100,000 and permitting securities brokers to market thrift CDs facilitated the rapid growth of some thrifts found to have the heaviest losses.

- ***Inadequate examiner staff.*** Though the size of the industry and the risk of its placements were expanding rapidly, the number of thrift examiners remained constant at roughly 1300 from 1979 through 1984.

- ***Accounting procedures.*** Thrift regulations permit loans and other assets to be carried at book value instead of current market value. Economists have generally argued for "mark-to-market" rules to evaluate assets. Although less cumbersome and subjective, the book-value method has permitted many thrifts to show strong balance sheets for years after a "mark-to-market" method would have revealed insolvency.

Of the 50 thrifts that were the most expensive for the FSLIC to resolve in 1988, 80 percent were state chartered, 74 percent had direct investment at least twice the industry average, 72 percent had brokered deposits a least twice the industry average, 50 percent violated the rules on loans to one borrower, and 50 percent had engaged in self-dealing loans to owners or management.

By early 1989, it had become apparent that the sick thrifts either still operating or hastily resolved at the end of 1988 had a combined negative net worth of $100 billion or more. The longer that they operated without intervention, the deeper they sunk. Desperate for funds to remain in business and with no capital of their own to lose, the sick thrifts paid high interest rates to attract funds, which led them to lend to riskier borrowers, who are the ones willing to pay higher interest rates. Strong and marginally healthy thrifts have also been hurt by the industry's crisis. Bad publicity has discouraged depositors, and sick thrifts competing for funds raise market interest rates for all.

Technically, the thrift industry is backed by a limited, industry-financed insurance fund that receives $2 billion a year in premiums. However, few have challenged the assumption of most depositors that the federal government (meaning the taxpayer) stands behind the deposit insurance of $100,000 per account. For the federal

government not to back up the insurance fund would fundamentally alter depositors' views of "insured" accounts, pillars of the U.S. financial system.

Solutions

The 1989 legislation seeks to reassure depositors of federal backing and to stem the ultimate cost to taxpayers of that backing:

- ***$50 billion.*** With $50 billion of additional funding over three years to close ailing institutions promptly and to finance the difference between assets and liabilities of thrifts closed or sold, regulators can expedite resolutions and not have to wait for insurance premiums to trickle in.

- ***Higher capital standards.*** The minimum capital requirement to operate a thrift will be raised over the next several years, and the definition of capital will be tightened.

- ***Limits on riskier assets.*** New rules phase out holdings of some riskier assets (e.g., junk bonds) and discourage others (e.g., direct investment).

- ***Reorganization.*** Thrift regulation has been shifted to the Office of Thrift Supervision within the Treasury. The Resolution Finance Corporation has been charged with raising funds for resolving the thrift crisis. The Resolution Trust Corporation (RTC) will manage assets (e.g., loans, property) that buyers of sick thrifts do not take on.

Now that the 1989 legislation has made these reforms, two clusters of issues bear close attention: the cost and operations of the mop-up, and the accuracy of the new accounting rules in depicting the financial health of thrifts.

The Administration expects to resolve 600 thrifts with assets nominally valued at $300 billion over the next several years. It expects that $200 billion of those assets can be turned over to acquiring thrifts or quickly sold on the market. However, it expects the RTC to manage $100 billion in assets (generally the least attractive, like problem loans and foreclosed property in weak real estate markets) for a period of time.

To close out sick thrifts while carrying those assets itself, the government must throw in new money in addition to the good assets of the resolved thrift to justify the new owner's assumption of the deposits and other liabilities. Thus, in the short term, it must borrow working capital of perhaps another $50 billion to $100 billion collateralized by the dubious assets that can neither be transferred to the new owner nor readily sold in the open market.

The 1989 legislation permits the RTC to borrow up to 85 percent of the fair market value of the assets that it carries. The Administration has proposed doing this through collateralized borrowing off-budget through a "bridge bank," but the chairmen of the Banking and Budget Committees have expressed the view that such borrowing should be on-budget.

In the interests of full disclosure, it makes sense to put such borrowing on budget. However, since this borrowing is not fiscally stimulative (because it merely restores the thrift deposits that the depositors always assumed they would recover), it should not be included in Gramm-Rudman deficit calculations -- either to raise the deficit when the borrowing takes place in the short term, or to lower the deficit when assets are sold and repayment occurs.

If the RTC's assets cannot ultimately be sold for the values now estimated, the true cost of the resolution of the thrift problem will be even higher. Most of the assets to be managed by the RTC are in the economically troubled Southwest. Tough choices must be made between forbearance and foreclosure of loans in arrears and between quickly selling off property and holding it in hopes of a rebound in property values.

Lawrence White testified before the Joint Economic Committee in October that the old accounting requirements for thrifts led to excessive risk-taking and hid the extent of the problem for several years. He emphasized that the new rules address the first more effectively than the second. The tighter capital requirements should keep thrifts from continuing to operate long after the owners' capital has dissipated, which led to excessive risk-taking. However, the new rules still permit assets to be valued according to book value rather than being revalued with changes in interest rates. When interest rates rise (fall), the market value of a mortgage declines (rises), much like a bond. If thrifts had used "mark-to-market" rules for revising the value of their assets in the 1980s, the extent of problem in the industry and in specific thrifts would have been apparent much sooner.

If funds already allocated prove indequate to close troubled thrifts, we should make up the difference quickly to prevent a worsening of those institutions' losses. Further we should provide adequate resources for safety and soundness regulation, and monitor the adequacy of the new rules with care.

The thrift crisis is an example of deregulation gone wrong, but deregulation has led to important efficiency improvements in other industries, most notably transportation. Committee witnesses pointed out significant price reductions in air, rail, and truck transportation. However, there are lessons to be learned. As in the thrift example, safety and soundness regulation should not be dropped by reflex when economic regulation is cut back. Antitrust enforcement is also a separate issue; our witnesses testified that anticompetitive mergers in the airline industry have unduly increased carrier concentration on some routes. Concern must be shown for small markets that could be adversely affected. Finally, neglect of our infrastructure base has led to congestion in air travel.

TRADE AND SUPER 301

The 1988 trade legislation gave the U.S. Trade Representative (USTR) an ambitious bilateral and multilateral agenda for 1989 and 1990. Bilaterally, under the "Super 301" provision, USTR must designate "priority countries" with a pattern of unfair trade barriers which, if lowered, would substantially benefit U.S. exports. The naming of priority countries and offending practices in May 1989 and May 1990 starts the clock on 12 to 18 months of intensive negotiations. If the negotiations fail to achieve

satisfactory agreements to reduce the specified barriers in a country, the U.S. would impose trade sanctions against certain exports from that country.

The 1988 trade act also directs USTR to seek multilateral agreements in a number of areas in the Uruguay Round of the General Agreement on Tariffs and Trade (GATT): agriculture, intellectual property protection, rules on foreign investment, and trade in services (e.g., banking, insurance, accounting, legal, construction, government procurement). The 1988 legislation and the American electoral cycle dictate that USTR conclude the Uruguay Round by the end of 1990.

Four decades of GATT negotiations have succeeded in dramatically lowering tariffs, particularly on manufactured goods and by the industrial countries. During the last two GATT rounds (the Kennedy Round of the 1960s and the Tokyo Round of the 1970s), the U.S. led efforts to develop tighter rules against non-tariff barriers (e.g., dumping, subsidies, government procurement, setting of technical standards). Often these barriers have been erected due to economic considerations that are largely domestic and not international. As a practical matter, few countries have been willing to commit to much change in their practices during these rounds. To reach agreements, the final language has been sufficiently ambiguous to permit signatory countries to continue largely as before.

Thus, the Congress gave a green light to the Uruguay Round but chose not to rely on the multilateral forum for reducing foreign barriers. The discussions that led to Super 301 focused particular attention on Japan as the largest market abroad, with steep and pervasive import barriers which are not susceptible to reduction in the Uruguay Round process, and with the broadest array of industries posing a competitive threat to major American industries. In the months just before its Super 301 decision in May, USTR engaged in successful negotiations with both Korea and Taiwan who were seeking to avoid being named. Both countries agreed to reduce a number of significant import barriers and did escape being named.

In making its first designations under Super 301 in May, USTR named three countries (Japan, India, and Brazil) and six practices. For Japan, USTR designated two government procurement policies (on satellites and on supercomputers) and the technical standards for forest products. India was named for two practices: trade-related investment measures (performance requirements and equity limitations) and barriers to trade in services (specifically insurance). Finally, USTR cited Brazil for a restrictive import licensing system.

All three countries objected to being named, complained that the U.S. was taking unilateral action contrary to GATT principles, and vowed not to negotiate with the U.S. under the Super 301 gun. The U.S. was roundly criticized by a large number of countries at a meeting of GATT representatives in June. USTR has nonetheless managed to engage all three governments in discussions on the designated practices.

The Administration announced both its Super 301 decisions and the launching of a "Structural Impediments Initiative" (SII) with Japan at the same press briefing. Led by the same agencies (State and Treasury) that had been conducting a similar "Structural Dialog" with Japan for several years, the discussions under SII encompass enforcement of competition laws, the distribution system, land use policy, farm policy, anticompetitive and exclusionary business practices, construction cartels, etc. On the

condition that the talks also encompass Japanese criticisms of U.S. policies affecting trade (e.g., budget deficit, low private savings and investment, management's short-time horizons, anti-dumping procedures, patent protection procedures), Japan has met twice for SII discussions. In the context of the SII, the two governments conducted a joint survey of identical name brand items in major cities in the two countries. Confirming U.S. charges of substantial import barriers in Japan, the survey revealed that prices in Japan averaged 40 percent higher than in the U.S.

It remains too early to judge the effectiveness of Super 301. Potential benefits, costs, and risks are substantial. As noted earlier, Super 301 has already permitted the U.S. to obtain significant barrier reductions in Korea and Taiwan.

If Super 301 talks break down with a country, the U.S. would impose trade sanctions against that country unless to do so were deemed contrary to U.S. economic or security interests. This could harm U.S. efforts in the Uruguay Round where each of the three named countries plays an important role. In a worst case scenario, U.S. sanctions are met with foreign retaliation. On the other hand, to the extent that the U.S. succeeds with a country under Super 301, that country should be an ally in pursuing tighter GATT rules on the subject.

At this early stage, USTR appears to have a reasonable chance of winning concessions and avoiding sanctions for all but one of the six practices named. (With private Indian firms prohibited from selling insurance in India since the government nationalized the industry in the early 1970s, the government seems unlikely to permit entry of foreign insurance firms.) Success will depend not only on the skill of U.S. negotiators but also on unrelated developments within each of the three countries (e.g., the outcome of national elections in Brazil this year and in Japan next year).

The first step toward solving our trade deficit should be reducing our budget deficit. Thereafter, we should encourage world trade, which is good for everyone, and resist protectionism and brokered (as opposed to free market) trade relationships. That requires opening markets in East Asia, keeping the European markets open in the 1992 initiative, and strengthening the economics of the Third World and the East Bloc.

TAKEOVERS AND LEVERAGED BUYOUTS

Despite a flurry of standing-room-only hearings, Congress ultimately declined to restrict hostile takeovers, leveraged buyouts (LBOs), and the high-risk, high-yield "junk bonds" that help finance them. Lawmakers failed to act in part because the market for takeovers weakened in 1989: Several buyouts faltered, and investment in junk bonds dwindled from its earlier peak. To many observers, including Administration officials, it appears that the financial markets are correcting perceived problems on their own.

The Congress' ambivalence also reflects the lack of consensus on the merits of widespread corporate restructuring. Proponents portray takeovers (and the threat of takeovers) as a way of moving corporate assets into more productive uses or into the hands of more effective managers. Critics see corporate raiders as a largely disruptive force leading managers to cut back on long-term investment and take on dangerously high levels of debt. The evidence is inconclusive. Both sides fault the tax code for encouraging corporations to favor debt over equity; but the importance of this incentive

is uncertain, and the Congress faces obstacles to solving that problem without creating others that are more serious.

Free Cash Flow Theory

Proponents of takeovers make a cogent theoretical case based on the notion of "free cash flow." Free cash flow – cash gains in excess of what firms can profitably reinvest – develops when a company has limited growth opportunities. Lacking such opportunities, an efficient firm would pay this cash out to shareholders in the form of dividends. Instead, many managers prefer to invest it in relatively unprofitable internal projects because their personal well-being is linked more closely to company expansion than to company profits.

According to this line of argument, firms run by such managers are attractive takeover targets because shareholders can easily be made better off. Oil companies, the first targets of corporate raiders in the early 1980s, are a prime example. Flush with profits created by the earlier fuel shortage, oil companies were investing in exploration and development at a level that the stock market felt was excessive in light of falling prices and the high cost of holding petroleum reserves. Takeover artists such as T. Boone Pickens forced target companies to retrench, producing enormous stock gains to shareholders.

Proponents maintain that stock prices of acquired oil companies also rose in response to the high debt levels imposed on them by the takeover process. By laying claim to discretionary cash, high debt forces managers to be efficient, much as a steep mortgage disciplines a would-be profligate. This disciplinary function of debt is said to be a major benefit of LBOs, which are financed almost entirely by debt.

If debt is the stick applied to managers by the buyout process, then ownership is the carrot. Many (though not all) LBOs involve heavy financial participation by managers – managers whose compensation has been only remotely linked to their firm's performance. (According to Michael Jensen of the Harvard Business School, the leading proponent of free cash flow theory, executives of large corporations receive only about $3.25 in additional salary, bonuses, and stock options for every $1,000 increase in shareholder wealth.) In theory, this greater financial stake discourages empire building and promotes managerial behavior that enhances the value of the firm.

Empirical Evidence

Productivity gains. The most dramatic evidence in support of takeovers is the large premiums to target shareholders, whose stock price typically is bid up by 30 to 50 percent. At a minimum, the stock market believes that new management and/or higher debt will increase profitability. As for actual performance, two relatively rigorous studies of LBOs conclude that there are productivity gains in the form of lower operating costs and higher operating profits in the years immediately following the buyout. Productivity growth is particularly high in LBOs that involve significant financial participation by management.

Although this is strong evidence, it is not conclusive. First, higher stock prices are not the ultimate proof of the value of takeovers. The stock market was demonstrably wrong in its enthusiastic reaction to the conglomerate mergers of the 1960s, many of which turned princes into frogs. Second, the higher stock prices, and in turn the improved profits, may not reflect genuine improvements in efficiency. Alternatively, the gains may come at the expense of some other group, such as taxpayers (who subsidize interest payments), employees (who may be forced to make wage concessions), bondholders (whose investment becomes riskier), or even bidder shareholders (who may have paid more than the target firm is worth). And, in fact, scattered research indicates that such transfers account for at least some of the gains from takeovers.

Long-term investment. Higher short-run profits may also come at the expense of long-term investment. The concern is that the threat of takeover, or the need to service large amounts of debt following a takeover, will force managers to defer investment in long-term activities such as research and development that will not affect revenues in the short run. Some observers have even speculated that takeovers are a major contributor to the slowed growth of U.S. corporate R&D in recent years.

Overall, very little is known about the effect of restructuring on firms' long-term investment and the implications of that for long-run economic strength. Nonetheless, one can venture a few preliminary judgments, based on a small number of studies on the impact of takeovers on R&D.

First, there is no systematic evidence to indicate that corporate restructuring leads to reduced research intensity -- that is, reduced R&D as a percentage of sales. However, if buyouts lead to diminished sales (LBOs are often motivated by the desire to downsize a firm), then one might observe a decline in the absolute level of R&D spending even though R&D intensity remains constant or increases.

Second, takeovers in the 1980s have been concentrated in industries with relatively low levels of R&D. Thus, the direct impact on aggregate industrial R&D in the U.S. is probably small. The possible indirect impact -- that is, the "chilling effect" on the R&D behavior of other firms -- remains unexplored.

Third, R&D spending has slowed significantly even among U.S. firms that have not undergone restructuring. Moreover, corporate R&D spending trends in the U.S. are similar to those abroad, where there have been relatively few takeovers. These patterns suggest that corporate restructuring is less important than other influences in explaining the recent slowed growth in U.S. company-funded R&D.

Macroeconomic risks of debt. Even if heavy debt leads individual firms to operate more efficiently, it may pose a risk to the U.S. economy as a whole. One danger is a "liquidity crisis" -- a temporary, sharp decrease in commercial lending triggered by, say, a major bankruptcy; if lenders fear more bankruptcies to come, even fundamentally solvent firms might be unable to get the cash to finance their short-term debt. A second and more disturbing danger is the "solvency crisis" that might result from a serious recession. Dwindling sales, together with rising interest rates, might make it difficult for highly leveraged firms to service their debt. The firms would respond by cutting back employment, production, and investment, but their retrenchment would affect other firms, thus deepening the recession. The more leveraged the U.S. economy is, the more slippery the recessionary slope could prove to be.

How likely are these scenarios? Although no one knows for sure, knowledgeable investors consider a macroeconomic debt crisis unlikely. Despite the rapid increase in debt, corporate debt-to-equity ratios have changed little during the 1980s, and they remain well below their 1973-74 peak. The fact that stock prices have risen in line with debt implies optimism on the part of the stock market about future earnings and the ability of firms to service their debt.

But if a debt crisis is unlikely, it is not impossible. Computer simulations by two Princeton University economists indicate that a recession as severe as that of 1973-74 would push one in ten large public firms into bankruptcy; more heavily leveraged private firms would presumably fare even worse. A repeat of the 1981-82 recession, though less damaging, might still trigger a liquidity crisis. In short, macroeconomic debt problems could be triggered by recessionary shocks of a magnitude that has been experienced twice in the last decade and a half. Such dangers could inhibit the Federal Reserve from taking necessary restrictive actions to fight inflation.

Proposals To Limit Takeovers

The most oft-mentioned device for discouraging takeovers is tax policy. Experts agree that the tax code's favorable treatment of debt relative to equity makes leveraged restructuring more attractive than it would otherwise be: The interest payments corporations make on debt finance are tax deductible to them, and taxable only to the bondholders. By contrast, corporate payments for equity -- i.e., stock dividends -- are taxable as corporate profits as well as to the stockholders. Thus, some leveraged takeovers may represent tax ploys rather than genuine efforts to enhance efficiency.

Despite expert agreement on the existence of the problem, its seriousness is uncertain. In fact, tax policy may already be headed in the right direction. The fact that takeover activity has peaked now that tax reform has reduced tax rates -- which in turn reduces both the value of interest deductions and the tax due on dividend payments -- may be no coincidence. There are also large obstacles to moving further. A tax deduction for dividend payments would have an uncertain impact on the problem -- possibly affecting the prices of deals more than the number of deals -- and cost the U.S. Treasury more than $30 billion a year distributed to the wealthiest taxpayers. On the other hand, taxing debt would put U.S. investors at a competitive disadvantage, since interest payments abroad are generally deductible. It would also hurt small business, which relies disproportionately on debt financing.

Alternatively, the Federal Government might take steps to increase the accountability of managers to shareholders -- for example, by eliminating legal barriers to paying managers profit-based compensation. This, together with reforms that hold outside directors to more rigorous responsibilities than merely attending meetings, might reduce the need to improve managerial incentives indirectly through high leverage.

U.S. TECHNOLOGY POLICY

High-definition television (HDTV) dominated this year's debate over U.S. competitiveness. Advocates of federal support for HDTV see this technology as a way both to keep the American semiconductor industry from falling farther behind Japan's and to help U.S. firms reenter the consumer electronics business. Critics, concerned that other technologies may be just as important, oppose government efforts to "pick winners and

losers." Chastened by charges that it was getting government into "industrial policy," the Bush Administration backed away from its initial enthusiasm toward HDTV.

As a side benefit, the HDTV debate helped to illuminate some complex issues. Experts used the op-ed pages of the *New York Times* and the *Wall Street Journal* to argue over the likely course of digital computer technology. Reports from Congressional research agencies and non-profit think tanks evaluated forecasts of consumer demand for HDTV and critiqued industry proposals for government assistance. Whatever its ultimate outcome, the debate illustrated that ideas do matter in Washington, and that contrary to what skeptics maintain, any government effort to pick winners and losers will involve economics as well as politics.

That said, one must fault the HDTV debate for obscuring other, perhaps more important policy issues. A program targeted at HDTV would do little to solve the more general and important problem: the weakness of U.S. engineering and manufacturing across the board. Federal policy needs to address that problem, through a fundamental shift in its current, science-based approach to technology policy. And it need not pick winners to do so.

Changes in the Technology Environment

It has become a truism that America invents and Japan commercializes. Since World War II, the U.S. has dominated in science, and American firms have made many if not most of the major technological breakthroughs (IBM's 1986 discovery of new, higher temperature superconducting materials is only the most recent example). But as industry moves along the learning curve, the competition quickly comes down to engineering and manufacturing, where Japanese and West German firms excel and U.S. firms often lag.

The strength of U.S. firms in science reflects past federal policy: Since World War II, this country's de facto technology policy has consisted largely of support for basic science and mission-oriented (primarily defense) technology development. That approach -- aimed at cultivating the technological frontier -- made sense in an era of overwhelming U.S. domination of world markets, and it ushered in a period of phenomenal scientific achievement. But three major changes have rendered our approach less effective in an era of strong international competition.

Foreign rivals. Most significant has been the emergence of foreign firms with the capacity to absorb and refine radical new technologies developed elsewhere, and access to world markets in which to achieve production economies of scale. In Japan, this corporate capacity reflects conscious government policies: to train large numbers of engineers, to promote investment in plant and advanced manufacturing equipment, and to speed technology diffusion via cooperative R&D and manufacturing extension services. Similarly, in West Germany, an elaborate system of vocational education, a network of research centers that provides technical support to small- and medium-sized firms, and a well developed system of industrial standardization all serve to promote technology diffusion and manufacturing excellence. Although a strong university science base supports West Germany's chemical and electrical industries, the thrust of that country's technology policy is to promote diffusion and manufacturing.

Two lessons emerge. Like the United States, both West Germany and Japan limit government's role in technology policy largely to activities that industry would not undertake on its own. But whereas the United States focuses on creating scientific knowledge and cultivating the technological frontier, West Germany and Japan focus on diffusing existing knowledge and refining technology at a subsequent stage in its trajectory. In short, there are different strategies for increasing national welfare through technology development.

To say there is more than one way to skin the cat called technology development, however, is not to say they are equally effective (lesson two). In general, the technological frontier does not appear to provide high rates of return on national investment because of the large R&D costs, the high risks of failure, and the ease with which radical new inventions can be imitated. Rather, the greatest potential for high profits comes at later stages in the development of a technology, where the largest improvements in product cost and performance occur. Stated simply, since pathbreaking inventions often cannot be protected from imitators, inventors must be able to control the manufacturing process in order to reap large rewards.

Merging of science and engineering. As superb manufacturers, Japan and West Germany have been able to get by without a uniformly strong science base. That is becoming harder to do, however, as distinctions between science and engineering continue to fade in key industries such as electronics -- a second change in the technology environment. With advances in the ability to characterize materials and processes, manufacturing itself is becoming ever more scientific. At the same time, R&D has become more closely linked to engineering, as market-based needs increasingly drive the research process.

This convergence of science and engineering has led Japan to make basic research a high priority in recent years. Ironically, as its advocates in the U.S. have long argued, science is the key to long-term economic improvement, but "the lock in which that key must turn is engineering," according to Lewis Branscomb, IBM's former chief scientist:

> When Americans return from our holiday from reality we will discover that science and technology, together with the wisdom and imagination to manage them properly, have become the new force in global change . . . . But we must also understand that science has changed the way technologies are generated and applied, and has done so in such a way as to enhance the economic value of strong science, but only provided it is coupled to strong engineering.

Divergence of military and civilian applications. In addition to basic science, the U.S. could once rely on applied research in defense technologies to yield important civilian applications. During the 1950s and 1960s, the semiconductor and computer industries both flourished in the hothouse environment provided by generous military and space program support for R&D and procurement. Many of the innovations in commercial aircraft were also initially developed for military applications.

However, military and space technologies are no longer a dominant source of commercial innovations -- a third major change in our technology environment. Military technologies have grown steadily more specialized, the defense sector more isolated from the rest of the economy. The direction of influence has even been reversed in many areas, where military applications now depend on advances in civilian tech-

nologies. Despite that, the U.S. continues to spend a far smaller percentage of its GNP on civilian R&D (1.8 percent) than West Germany or Japan (2.7 percent).

Policy Prescriptions

The existing U.S. research system has enormous strengths, including an unparalleled university research platform, a large pool of scientific talent, and a flexible and efficient government structure for funding leading-edge research. The answer to our competitive problems is not to divert resources from science and thereby risk losing our longstanding advantage. But we must acknowledge the fundamental changes that have occurred in the last forty years and adapt our approach accordingly.

First, we must begin to support non-proprietary research in (civilian) engineering -- areas such as measurement and characterization of materials and processes, production systems engineering, and design for manufacturability. As Branscomb argues, the debate over appropriate roles for government investment should be framed as generic versus appropriable research, not as science versus engineering. To be sure, government must avoid simply replacing private dollars with public ones; but this can be accomplished by following the same criteria for engineering research that the National Science Foundation follows for science: namely, research that is timely; has high intellectual value, application potential, or both; and is unlikely to be funded by industry.

Second, Federal policy should actively promote the diffusion and adoption of existing scientific and technological knowledge, not just the creation of new knowledge. Congress has taken several small steps in that direction in recent years, including the 1986 Federal Technology Transfer Act, designed to encourage the transfer of technology from Federal laboratories. Potentially even more important, the Omnibus Trade and Competitiveness Act of 1988 created the framework for a broader program of manufacturing technology extension geared to small and mid-sized firms. Unfortunately, Congress has not fully funded the program in either 1988 or 1989 (the trade act authorized $22 million a year for manufacturing extension, but the Congress appropriated only $5 million in 1988 and $7.5 million in 1989), and the Administration budget for 1990 contains no funds for the trade act's technology extension provisions.

Total state and Federal spending on manufacturing extension is still well under $100 million a year. That pales in comparison to the Agricultural Extension Service -- with its annual funding of more than $1 billion (30 percent Federal) -- despite the fact that agriculture contributes only two percent to GNP whereas manufacturing contributes 19 percent. U.S. efforts also compare poorly to Japan's, where a massive network of public testing and research centers provides technology extension to smaller manufacturing firms. In 1985, Japan had 185 of these centers, with 7,000 employees and annual funding of $0.5 billion, half from the national government and half from the prefectures. Greater U.S. efforts in this area would address a weakness identified in a recent MIT study: that many of our firms lag behind our own best practice in manufacturing.

Third, in funding R&D, we should reverse the systematic shift away from areas with the greatest potential for contributing to commercial innovations. The Federal Government spends over $60 billion a year on R&D -- more in absolute terms than the Japanese and West German governments combined. But nearly 70 percent goes for defense, up from 57 percent at the start of the Reagan Administration. And DOD support for basic research as a fraction of its Research, Developing, Testing and

Evaluation (RDT&E) function is now less than half what it was in the mid-1960s (roughly 2 percent in 1988 compared to 5 percent in 1965). It is in our defense interest, as well as our economic interest, to return to a pattern of relatively greater support for generic research and technology development.

IMPROVING FEDERAL RESERVE PROCEDURES

The Federal Reserve occupies an anomalous position within the government of the United States. It is an enormously powerful institution, but it does not conform to normal standards of government accountability. Power without accountability simply does not fit in the American system of democracy.

No other government agency enjoys the Fed's prerogatives. Monetary policy is conducted in secret, behind closed doors. The Federal Reserve is not required to consult with the Congress or the Administration before setting money or interest rate targets. It waits six weeks before releasing policy decisions. The President, who is responsible for the performance of the economy and is blamed if things go wrong, often must wait until late in his term to appoint a new Chairman of the Federal Reserve Board. The Fed's budget is not published in the U.S. Government Budget, even though it spends over $1.5 billion per year. The Presidents of the 12 Federal Reserve Banks, who participate in monetary policy decisions on the FOMC, are neither appointed by the President nor confirmed by the Senate. Even though the Federal Reserve engages in more than $1 trillion in transactions in the money markets each year, most of these activities are exempt from audit by the GAO or any other outside agency.

The solution is to make the Federal Reserve more accountable to the American people, by creating a formal channel of communication between the President and the Federal Reserve, and by providing the Congress and the American people with more and better information on the Federal Reserve's policies and procedures. This could be done with five modest changes in the current practices and procedures of the Federal Reserve, as proposed in H.R. 3512 (co-sponsored by Congressman Byron Dorgan (D-ND)).

The bill would require the Federal Open Market Committee, the arm of the Federal Reserve which actually sets monetary policy, to meet three times a year with the President's chief economic advisers: the Secretary of the Treasury, the Chairman of the Council of Economic Advisers, and the Director of the Office of Management and Budget. Two meetings would take place just before the FOMC sets its annual money growth targets in February and July and reports to the Congress, as required by the Full Employment and Balanced Growth Act of 1978. The third meeting would occur in the fall at the start of the Administration's annual budget cycle. These meetings will provide Administration with a formal avenue to present its economic goals and programs to the FOMC, and give FOMC members an opportunity to convey their concerns about fiscal policy to the Administration. Communication would flow both ways. The only channels of communication that currently exist are informal ones. It is astonishing that the world's greatest economic power does not have a formal channel of communication between the key makers of economic policy.

The second provision would allow the President to appoint a Chairman of the Federal Reserve Board one year after taking office (when there would normally be a vacancy on the Board), making the Chairman's term basically coterminous with the President's. The current Chairman of the Board of Governors, Alan Greenspan, was appointed by President Bush's predecessor and will hold that office until August 10, 1991, almost three years into President Bush's term. Fortunately, Chairman Greenspan and President Bush have a cordial relationship. But if they were unable to work together, the result could be serious damage to the American economy and a paralysis of economic policy. This is a risk the country should not take. In testimony before Congressional Committees, former Federal Reserve Board Chairmen William McChesney Martin and Paul Volcker endorsed this proposed change.

The third provision would require the FOMC to disclose immediately any changes in the targets of monetary policy, including its targets for monetary aggregates, credit aggregates, prices, interest rates, or bank reserves. The FOMC currently keeps major policy decisions secret for six weeks after they are made and carried out. While the delay may help insulate the Federal Reserve from criticism, secrecy has two economic costs. First, secrecy makes capital markets operate less efficiently. The delay can be defended only if ignorance is better than knowledge; but a fundamental tenet of microeconomic theory is that markets work best with complete information. Second, secrecy is unfair to small investors; large investors, with the resources to employ experts to interpret policy moves, have a major advantage. The bill would not require the Federal Reserve to announce every day-to-day move it makes in conducting monetary policy or impair its ability to react quickly in a crisis. This change is widely supported by economists and participants in the financial markets.

HR 3512 would also permit the Comptroller General to conduct more thorough audits of Federal Reserve operations, by lifting selected prohibitions against GAO access to the Federal Reserve. Most of the Federal Reserve's practices and procedures are not subject to outside review. The lesson of the HUD and FSLIC scandals is that no government agency should be exempt from outside audits.

The final provision of the bill would require that the Federal Reserve's annual budget be published in the Budget of the U.S. Government. The Fed would submit its budget for the current year and the two following years to the President by October 16 of each year, and the President would be required to print the Fed's budget in the Government Budget without change. At present, only 6 percent of the Fed's expenses are included in the U.S. Government Budget -- just the $90 million incurred by the Board of Governors in Washington -- in the Appendix. The bill would not subject the Federal Reserve to the Congressional appropriations process, nor would it give either the Congress or the Administration any control over the Federal Reserve's spending. All it does is require that the data be published in the same document where spending by every other government agency is listed.

H.R. 3512 is a modest bill designed to increase the accountability of the Federal Reserve without reducing its policy-making independence or injecting politics into monetary policy. It takes advantage of a period of high regard for the Fed, and a moment of economic calm, to bring Fed procedures up to date. If we wait to make the necessary adjustments until a time of economic turbulence and controversy, the results may be far less measured.

CAPITAL GAINS AND TAX REFORM

The House of Representatives passed a capital gains tax cut as part of its budget reconciliation package this year, but the Senate, after considerable parliamentary maneuvering, did not. This issue is almost certain to reappear in 1990.

Preferential treatment of capital gains was introduced into the income tax in 1922. For most of the succeeding years, the law has allowed a certain percentage of capital gains on assets held for some minimum time to be tax free. In 1978, the excluded portion of capital gains was increased from 50 percent to 60 percent; in 1984, the minimum holding period to qualify for the exclusion was shortened from one year to six months; and when the general tax rate cuts were phased in over 1981-84, tax rates on capital gains fell by the same percentage.

In 1986, as part of the tax reform compact that reduced the tax rate for the highest-income taxpayers from 50 percent to 28 percent, the capital gains exclusion was repealed; capital gains are now taxed at the same rate as ordinary income. Repeal was intended to offset part, but not all, of the benefit of the substantial rate cut; to restrain tax sheltering, which was driven in part by the conversion of fully taxed ordinary income into partly excluded capital gain; and to make the tax law more neutral between investments that yield capital gains and others that yield interest, dividends, or other forms of income.

The proposals to reintroduce a capital gains exclusion were motivated in part by a concern for fair treatment of taxpayers who held slowly appreciating assets over a long time during inflation; retired homeowners and small business owners were prominently mentioned. However, this argument was undermined by the proposals themselves, because the exclusion is far more generous to taxpayers who held rapidly appreciating assets over a short time -- highly successful stock market investors, for example. (The House bill would have converted the exclusion into a precise correction for inflation in 1992, but capital gains advocates spoke openly of repealing that change before the appointed date. The Senate bill dropped the pretense and called for a permanent exclusion.) Further, home sellers 55 and older already have a one-time exclusion of $125,000 of capital gain, and targeted relief for home sellers and small business sellers would have cost a small fraction of the revenue loss of a general tax cut.

A second argument for the capital gains tax cut was the stimulation of investment, productivity, and economic growth. However, no study has ever identified any economic benefit from an actual capital gains tax cut. The Reagan Treasury in 1985 used a theoretical model to estimate that the 1978 capital gains tax cut would increase the growth of national income by at most 0.005 percent per year -- an effect that the study admitted "could not be detected" in any actual data. And the capital gains tax rate for the highest-income taxpayers is already as low as it was after the 1978 capital gains tax cut.

Another alleged benefit of a capital gains tax preference was an increased flow of venture capital to new businesses; a rapid increase in venture capital after 1978 has been attributed to that capital gains tax cut. However, industry figures show that as much as 85 percent of venture capital came from foreigners or U.S. institutions not subject to capital gains taxation. The liberalization of pension fund portfolio restrictions

may have been more responsible for the growth of venture capital than the capital gains tax cut.

The final argument for a capital gains tax cut was an alleged increase in revenue; it was claimed that the lower tax rate would lead to a faster turnover of assets, and therefore significantly more gains realized. However, in past capital gains tax cuts, that effect was only temporary. A long-term revenue loss would be particularly unwelcome at this time, when a large deficit already drains scarce national saving.

The costs of a capital gains tax cut would not be limited to revenue. Lower taxes on capital gains than other income would revive the tax shelter industry, and would increase the budget deficit. Further, a preference for capital gains would provide tax relief to those who need it least; in 1987 (the latest year for which data are available), the top one-half of one percent of taxpayers received about 10 percent of total income, but more than half of all capital gains. The proposed capital gains exclusion would be a serious error in tax and budget policy.

Perhaps the most serious cost of a capital gains tax cut would be its threat to tax reform. The low tax rates enacted in 1986 were universally hailed as a major improvement; the only reservation expressed was a fear that repeal of tax incentives for investment and saving would slow the economy. Since 1986, however, investment and saving have if anything improved. It seems that tax reformers were correct when they argued that taxes were a weak influence on the total amount of investment and saving, and have a significant effect only on the form of investment or saving chosen. It follows that the tax law should have the least possible influence on that choice, so that the market directs funds to their most profitable uses. Given the excellent track record of tax reform, we should avoid the reintroduction of tax preferences that might lead to increases in ordinary tax rates and perhaps the gradual unravelling of tax reform.